Annual Report 2009

# Morningstar Fund Flows and Investment Trends

A robust market recovery in 2009 helped funds make up some of the ground lost to outflows in 2008. In total, U.S. mutual funds took in $377 billion for the year and ETFs gathered $104 billion. Some of the inflows into long-term funds came from money market funds, which registered outflows of $392 billion in 2009. On the separate-account side, net inflows came to $80 billion for 2009, with an additional $24 billion flowing into separate account money market accounts.

2009 Estimated Net Flow by Investment Type and Asset Class ($Mil)

| Asset Class | Open-End ex Funds of Funds | ETFs | Separate Accounts & CITs | Variable Annuities | All |
|---|---|---|---|---|---|
| U.S. Stock | (25,330) | (14,464) | (44,488) | 15,629 | (68,653) |
| International Stock | 25,542 | 28,781 | 23,826 | 4,006 | 82,155 |
| Balanced | (3,660) | 341 | (1,811) | 43,017 | 37,887 |
| Taxable Bond | 284,403 | 35,314 | 70,100 | 14,564 | 404,381 |
| Municipal Bond | 72,097 | 3,387 | 22,610 | -- | 98,094 |
| Alternative | 14,175 | 24,194 | 5,403 | 115 | 43,887 |
| Commodities | 10,224 | 26,509 | 4,538 | -- | 41,271 |
| All Long Term | 377, 450 | 104,062 | 80,178 | 51,213 | 235,453 |
| Money Market | (392,231) | -- | 23,601 | (18,107) | (386,737) |

Source: Morningstar Direct Fund Flows

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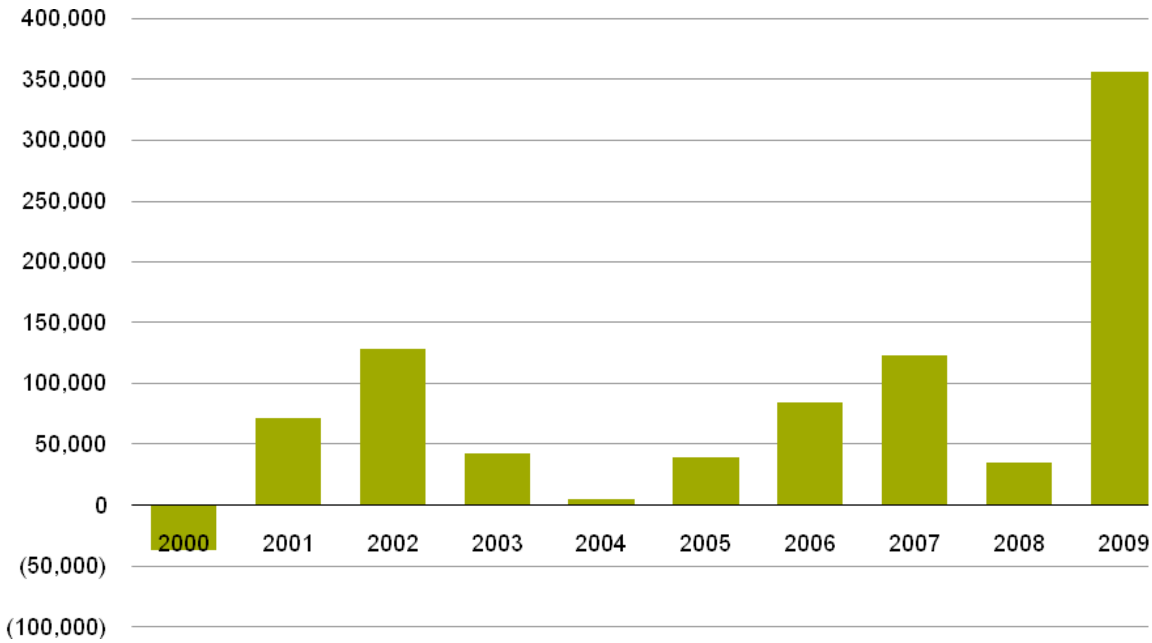
This report is a collection of research articles intended to provide food for thought to industry insiders and outside observers alike.

## Will New Bond Fund Aficionados Stick Around?

Sonya Morris, CFA, Editorial Director

Investors flooded bond funds with cash in 2009. For the year, U.S. open-end bond funds took in $357 billion, far more than any other asset class. For perspective, fixed-income funds took in more flows in 2009 than they saw over the previous five calendar years combined.

**Estimated Flows OE Bond Funds** ($mil)




Source: Morningstar Direct Fund Flows

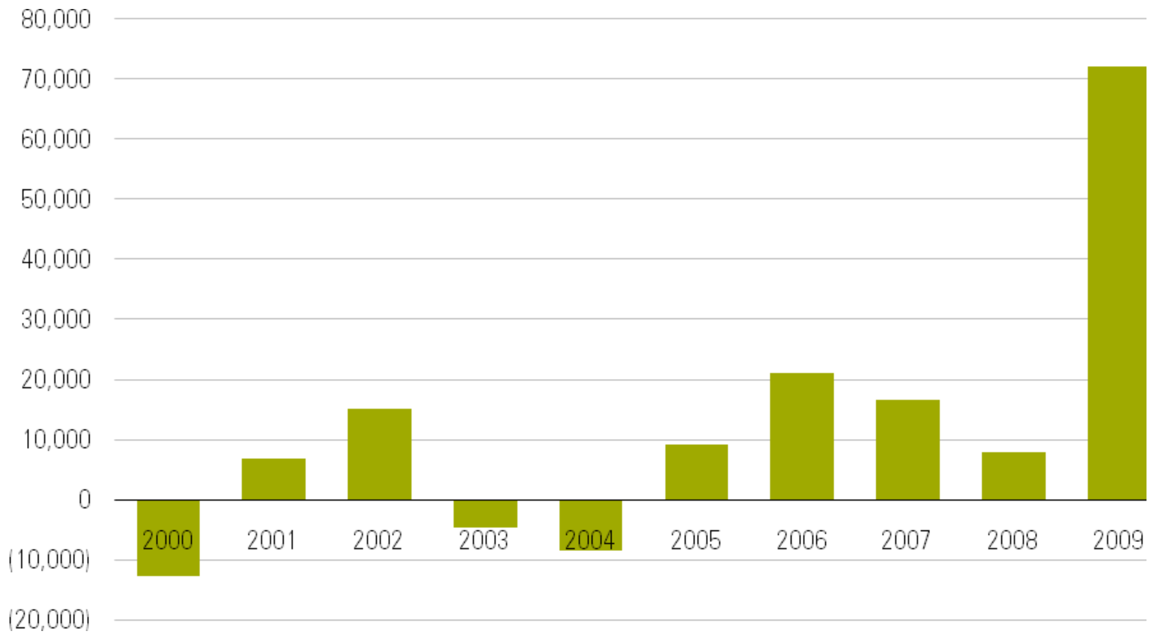
Several factors explain this stampede. Low yields in other income-producing investments, such as money market accounts and bank CDs, likely pushed some income-hungry investors into bond funds. There was probably a bit of performance-chasing going on, too. Bonds held up better than most other asset classes in 2008, and they also outperformed equities for the decade, as measured by the major market indexes. Finally, and perhaps most importantly, after experiencing harrowing losses in 2008, many investors may have reassessed their capacity for risk and increased their portfolios' allocations to lower-volatility asset classes.

True, bond funds can serve to smooth out total ortfolio returns; however, they aren't immune from volatility. In fact, there are risks looming on the horizon that many new shareholders may not fully appreciate. If these risks reveal themselves, it could test the patience and loyalty of these newfound bond investors, particularly if their expectations are unreasonable. Here are a few areas to watch in 2010.

### Credit Worries Hang Over Muni-Bond Funds

Taxable bond funds accounted for most fixed-income flows in 2009, but on a historical basis, muni funds had a banner year, gathering an unprecedented $72 billion in assets. That blew away the previous record of $21 billion in 2006.

**Estimated Flows OE Municipal Bond Funds ($mil)**




Source: Morningstar Direct Fund Flows

The factors that have fueled flows into taxable bond funds--low yields and investors' risk-averse mood--also buoyed muni-fund flows in 2009. In addition, many have increasingly turned to tax-conscious funds in anticipation of higher tax rates in 2011, when the tax cuts enacted during the Bush administration are set to expire.

Those demand-side factors will likely continue to work in favor of munis in 2010. At the same time, supply will be limited as the Build America Bonds program makes it more attractive for traditional muni issuers to gain financing via the taxable bond market. Those technical factors could support muni bonds in the coming months.

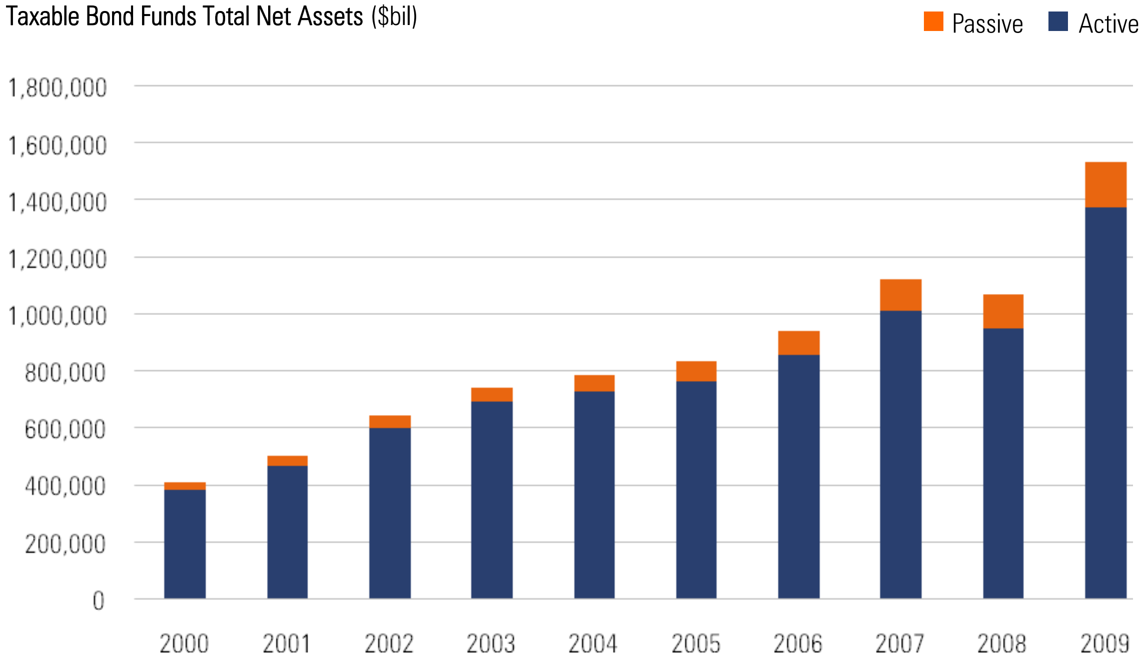
On the other hand, storm clouds are brewing over state and municipal governments. They've seen tax revenues decline just as the demands on their resources are increasing. California may be capturing all the headlines, but many other states have seen their financial conditions deteriorate. To top it off, these credit-quality worries are rising to the surface after muni-bond insurance has faded to the background. Fund managers we talk to aren't expecting massive defaults, but downgrade risk is a real concern, and many have ramped up their credit-research efforts as a result.

If credit-quality issues overshadow the positive technical backdrop, muni-fund shareholders could be in for some volatility over the near- to intermediate-term. The risk may be the greatest for short-term muni funds, which captured nearly half of the flows into muni-bond funds in 2009. That rush of cash helped push valuations of short-term munis to lofty levels, according to some managers, leaving them vulnerable to the slightest hint of bad news. These funds are not immune to losses over the short run, and that could test the staying power of those who turned to short-term muni funds in lieu of money markets.

**Bond Index Funds Face Headwinds**

Although the vast majority of investors preferred active bond funds, a noteworthy amount of inflows went to bond index funds, most notably Vanguard Total Bond Market II and Vanguard Total Bond Market, which took in almost $23 billion combined in 2009. Based on total net assets, passive strategies represent around 11% of the taxable bond fund market.

Taxable Bond Funds Total Net Assets ($bil)




Source: Morningstar Direct Fund Flows

Index funds are hardly high risk; they are designed to provide broad, diversified exposure to an asset class. For the most part, they do exactly that. But bond index funds, many of which track the Barclays Capital U.S. Aggregate Bond Index, may face headwinds over the near term because they currently own outsized portions of government-backed bonds. Here's why: When the credit crisis struck, investors fled to the safety of Treasury bonds, boosting valuations in the sector, while increased issuance should continue to raise its weighting in fixed-income indexes. Although panicked buying of Treasuries abated in 2009, the government's influence on bond indexes has continued via agency mortgage securities. Prices of those securities have been supported by the Fed's buying program, which targets purchases of $1.25 trillion in agency mortgage-backed securities and $175 billion in agency bonds.

At year-end 2009, Treasuries, agency mortgages, and other government-related bonds made up roughly three quarters of the Barclays Capital U.S. Aggregate Bond Index. Treasuries alone accounted for 28% of the index's assets, compared with just 13% for the typical intermediate-term bond fund. Meanwhile, the index's weighting to corporate bonds amounted to just 18%, half the category average.

Securities backed by the U.S. government are still considered some of the safest investments in the world, but that doesn't mean they are risk-free. For example, price risk is a concern at the moment. Neither Treasury bonds nor agency mortgage-backed securities can be considered attractively priced. For example, current yields of 2.2% and 3.9% on the Barclays Capital U.S. Treasury and U.S. Mortgage-Backed Securities indexes, respectively, hover near historic lows.

The prices of agency bonds and mortgage-backed securities have been artificially lifted by the Federal Reserve, but the Fed is scheduled to end its buying program in March 2010, which could put pressure on the prices of these securities.

Interest-rate risk is also a worry, though perhaps not a pressing one. Higher-quality bonds (like Treasuries and government-backed mortgages) are more vulnerable to rises in interest rates than lower-rated bonds. Although many economists and fund managers aren't expecting imminent rate hikes from the Fed, interest rates will eventually rise and when they do, Treasury and agency mortgage bond prices will come under pressure. At the same time, higher interest rates mean higher yields on money market accounts and CDs, making them viable alternatives to bond funds.

Bond index funds are currently more exposed to these risks than most actively managed fixed-income funds because of the prominence of government-backed securities in the Barclays Capital U.S. Aggregate Bond Index. For that reason, Vanguard recently changed Total Bond Market Index's benchmark to the newly minted float-adjusted version of the index, which slightly tempers the prominence of agency mortgage-backed securities in the index, and that could serve to moderate these risks somewhat.

**Ultrashort Memories?**

Ultrashort bond funds gathered $13.8 billion in 2009, making it the 10th-most-popular fund category for the year. That more than makes up for the $10.7 billion in total outflows the category experienced in 2007 and 2008. This reversal of fortune is remarkable when you consider the spectacular blowups the category witnessed in 2008, including Schwab Yield Plus, and the now defunct SSgA YieldPlus and Evergreen Ultra Short Opportunities. Perhaps investors have short memories. More likely, their desire for yield in today's low-interest-rate environment has trumped other concerns.

There is some comfort in the fact that the bulk of the new inflows have gone to some of the more judicious funds in the category, such as PIMCO Short-Term (which accounted for half of the category's inflows in 2009), Franklin Adjustable U.S. Government Securities, and DFA One-Year Fixed-Income. Such funds came through 2008 relatively unscathed, and it is hoped they'll continue to meet shareholders' expectations for a relatively smooth ride.

**Shareholders' Staying Power May Be Tested**

In sum, with risks looming, bond-fund returns could come under pressure. That could shake out investors who don't have realistic expectations about bond-fund volatility. In 1999, the last time the fixed-income market experienced a downturn, bond funds saw noteworthy outflows that began later that year and continued throughout most of 2000. From September 1999 through December 2000, $57.8 billion exited bond funds. But they quickly made up that lost ground in 2001 and 2002 when investors once again sought shelter from the crumbling stock market.

A downturn in the bond market will likely cause some shareholders to dump their bond funds, but the level of outflows will depend on the factors that have driven investors to the asset class in the first place. For example, if rising rates allow CDs or money market funds to offer attractive yields, bond funds could face serious competition. On the other hand, if fixed-income funds manage to limit volatility relative to other asset classes, they stand a good chance of holding on to their shareholders. Only time will tell.

## Wealth Creators and Destroyers

Sonya Morris, CFA, Editorial Director

Total returns are the traditional, and best, measure of a fund's performance. But it can be telling to translate returns into hard dollars, particularly when the amounts at stake are huge. This way, you can see which strategies are working, particularly on a large scale, and which are not. In total, open-end fund firms manage more than $7 trillion in assets for U.S. investors (exclusive of money market funds and exchange-traded funds), but how much money have funds made for their shareholders over time?

To answer that question, we calculated the total wealth created and destroyed over the course of the decade by focusing on asset growth that wasn't due to fund flows. The calculation began with total net assets at the end of 1999. We subtracted cash flows over the decade and then deducted total net assets at the end of 2009. We computed results for Morningstar fund categories and the largest 50 funds firms (as measured by total net mutual fund assets). We included both existing and extinct funds in our calculation as both contributed to the industry's results over the decade. That's another advantage that dollar totals have--they let you see which firms and categories have lost money even if they later merge their mistakes away. The tables below present the top wealth creators and worst wealth destroyers over the decade, along with the asset-weighted returns over that period.

### Top Wealth Creators

| **Category** | **Wealth Created** ($mil) |
|---|---|
| Intermediate-Term Bond | 192,611 |
| Large Blend | 144,053 |
| Moderate Allocation | 124,654 |
| Large Value | 116,729 |
| Foreign Large Blend | 62,884 |

| **Fund Firm** | **Wealth Created** ($mil) |
|---|---|
| American Funds | 190,953 |
| Vanguard | 188,959 |
| Fidelity | 153,082 |
| Franklin Templeton | 78,442 |
| PIMCO | 71,381 |

Source: Morningstar Direct Fund Flows

### Biggest Wealth Destroyers

| **Category** | **Wealth Destroyed** ($mil) |
|---|---|
| Large Growth | (107,579) |
| Technology | (62,805) |
| Europe Stock | (12,738) |
| Diversified Pacific/Asia | (5,332) |
| Mid-Cap Growth | (3,869) |

| **Fund Firm** | **Wealth Destroyed** ($mil) |
|---|---|
| Janus | (58,397) |
| Putnam | (46,407) |
| AllianceBernstein | (11,376) |
| Invesco AIM | (10,081) |
| MFS | (7,651) |

Source: Morningstar Direct Fund Flows

**Where's the Love?**

The firms and categories with the biggest asset bases are naturally more likely to end up at the top or bottom of these lists. Still, some of these results run counter to fund investors' recent tastes. Some of the categories that have created the most wealth over the past decade have been the least popular with investors recently. For example, in 2009, moderate-allocation funds registered outflows of $17.6 billion, making it the second-most-redeemed category for the year behind large growth. Large value wasn't far behind with $17.0 billion in outflows. And while large blend managed to keep flows positive, the category took in a rather tepid $5.2 billion in assets last year.

By the same token, American Funds created more wealth than any other fund firm over the past 10 years, yet in 2009, it experienced bigger outflows than any other fund company by far, with more than $25 billion going out the door.

Could this be a contrarian indicator? Morningstar studies have shown that the fund categories with the greatest inflows tend to underperform those with the greatest outflows over the ensuing three- and five-year periods. Things could be looking up for American Funds and large-cap and moderate-allocation funds.

**Performance-Chasers Beware**

Measured by wealth destroyed, large-growth and technology funds were the worst-performing fund categories for the decade by far. These categories lagged many other market segments over the course of the decade, returning losses of 6.8% and 2.1%, respectively, compared with a loss of 0.1% for the Morningstar Total Market Index. But the results are also influenced by the time period of the study. Growth and technology funds began the decade with hefty asset bases, their popularity buoyed by the dot-com boom. Fund companies stoked the fire by launching a slew of tech funds when the sector was at its hottest. When the bubble burst, investors fled for the exits in droves.

That classic cycle of greed and fear always ends badly for investors, and the extent of the damage is made clear by the wealth collectively destroyed by these funds. Although shareholders can be their own worst enemies, fund companies aren't innocent bystanders. Too often, they prey on investors' worst instincts by launching funds in overheated market segments. This behavior was at its worst during the dot-com craze: Between 1999 and 2000, 135 technology funds were launched. That terrible timing cost investors plenty.

Not all of the fund firms that destroyed wealth over the period were guilty of that behavior. However, all had lineups that were skewed toward growth equities, including some fairly aggressive offerings that produced eye-popping gains during the tech boom. As a result, they began the 10-year period with sizable asset bases. But their high-flying funds came down hard in the ensuing bear market, shaking the faith of their fundholders. Making matters worse, all five of the top wealth destroyers were implicated in the market-timing scandal of 2003, further eroding shareholders' trust. As a result, four of the five had net outflows over the 10-year period. That result was also likely influenced by the fact that some firms made significant changes to their distribution models. To top it off, these firms' funds had mixed-to-poor performance over the course of the decade, making it difficult for them to create wealth for the shareholders who remained.

All of these firms have taken steps to turn things around and to address the mistakes of the past, but only two (MFS and Janus) have seen meaningful improvement in mutual fund flows.

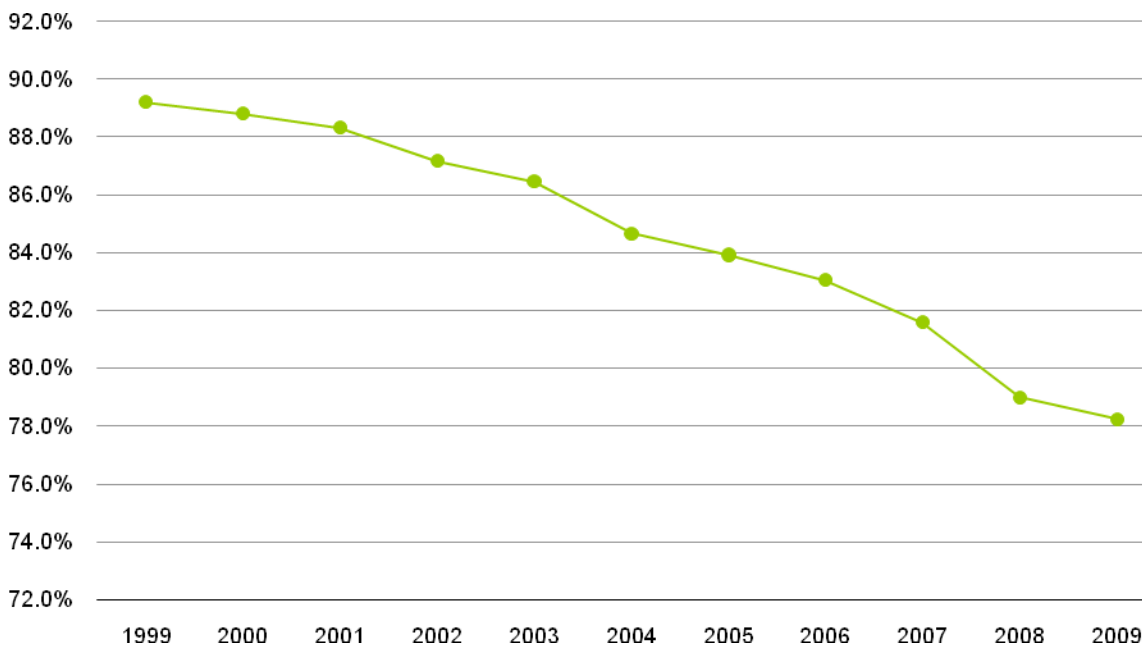
## Passive Funds Continue to Take Market Share

Sonya Morris, CFA, Editorial Director

The active/passive debate rages on in the investor community. If investors are voting with their dollars, active funds have a strong lead based on total net assets. At year end 2009, active strategies held more than $6 trillion in assets, while passive assets totaled almost $1.7 trillion. (These figures include both the open-end and the exchange-traded markets.)

However, passive strategies have become increasingly popular in recent years, and their advance has been hastened by the growth of the ETF market. Over the past decade, passive strategies have taken noteworthy market share from active funds. Active funds began the decade with an 89% share of the market, but that had shrunk to 78% by the end of 2009.

**Actively Managed Market Share**



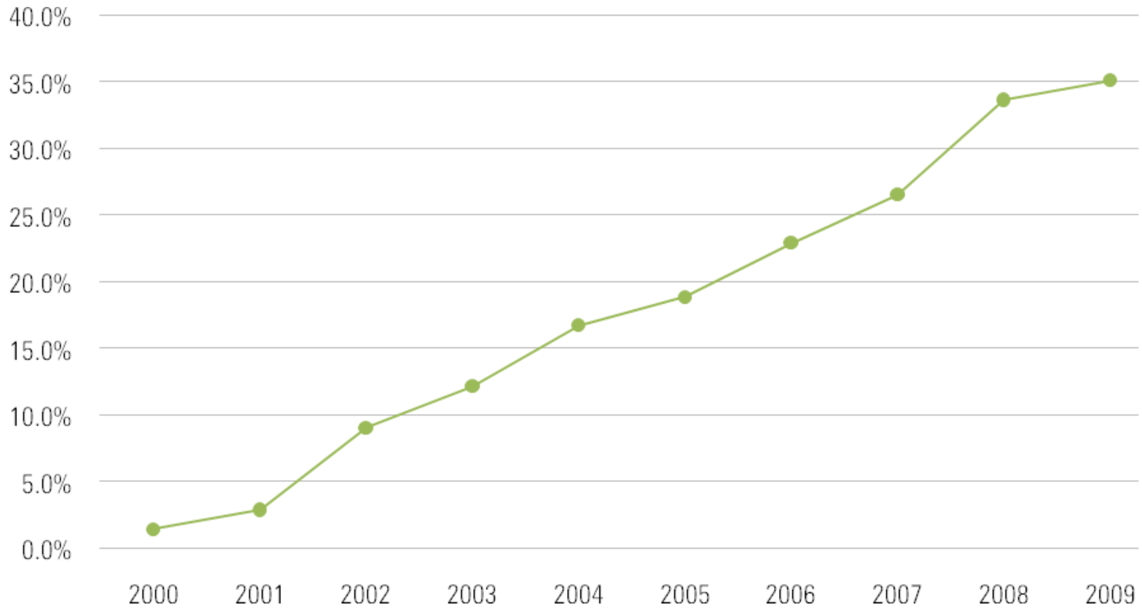

Source: Morningstar Direct Fund Flows

| Asset Class | Passive Mkt Share % 2000 | Passive Mkt Share % 2009 |
|---|---|---|
| Alternative | 8% | 37% |
| Balanced | 2% | 2% |
| Commodities | 0% | 77% |
| International Stock | 6% | 25% |
| Municipal Bond | 0% | 2% |
| Taxable Bond | 6% | 16% |
| US Stock | 15% | 27% |

Source: Morningstar Direct Fund Flows

In recent years, it seems as if open-end funds have ceded the sector-fund territory to ETFs. Passive sector funds began the decade with just $2.6 billion in assets out of a total of $173 billion for a slim market share of 1.5%. But as the menu of sector ETFs grew, investors turned to them in increasing numbers. By the end of 2009, assets in passive sector funds totaled almost $92 billion, representing a market share of 35%.

**Sector Funds: Passive Market Share**




Source: [Morningstar Direct Fund Flows]

Fidelity is the biggest player when it comes to active sector funds, but sector funds have continued to lose ground to sector ETFs. The firm's share of sector-fund assets has declined from around 20% in 2000 to 11% in 2009

## ETFs: 2009 Year-in-Review

John Gabriel, ETF Analyst

The U.S. exchange-traded fund industry continues to evolve and attract assets. U.S. ETFs closed out 2009 with $785 billion in assets, up from roughly $533 billion at the end of 2008. In 2009, investors poured $104.1 billion in net new assets into ETFs, following a banner year in 2008 that saw ETFs draw some $156.6 billion in net inflows. Of the industry’s 47% increase in year-over-year total net assets, roughly 40% was attributable to net inflows over the past year, while the remaining 60% was due to strong market performance.

A total of 134 new ETFs were launched in 2009. There was a relatively broad range of funds introduced over the course of the year, with U.S. equity (37 ETF launches last year), leveraged and inverse (33), fixed-income (30), and international equity (24) being the most popular categories, in terms of product proliferation.

Meanwhile, 54 ETFs were shuttered, 12 of which were exchange-traded notes. For some context, we saw 58 ETFs close in 2008, eight of which were ETNs. Northern Trust threw in the towel on its ETF business in 2009, shuttering all 17 of its internationally focused ETFs. SPA-ETFs also folded in 2009 and closed its six ETNs in March 2009. PowerShares trimmed its fund lineup by closing 19 of its funds in May 2009; the liquidated funds included the firm's FTSE RAFI sector ETFs and dynamic international ETFs.

### Fund Industry Giants Jump on ETF Bandwagon

In 2009, industry heavyweights Charles Schwab and PIMCO tossed their hats into the ETF ring. Schwab's debut made waves, as the firm offered commission-free trading on its ETFs for any investor trading on the firm's platform. The firm enjoyed a healthy response from investors and closed out January 2010 with more than $500 million in assets in the new funds, which is impressive considering that the funds didn't begin trading until November 2009.

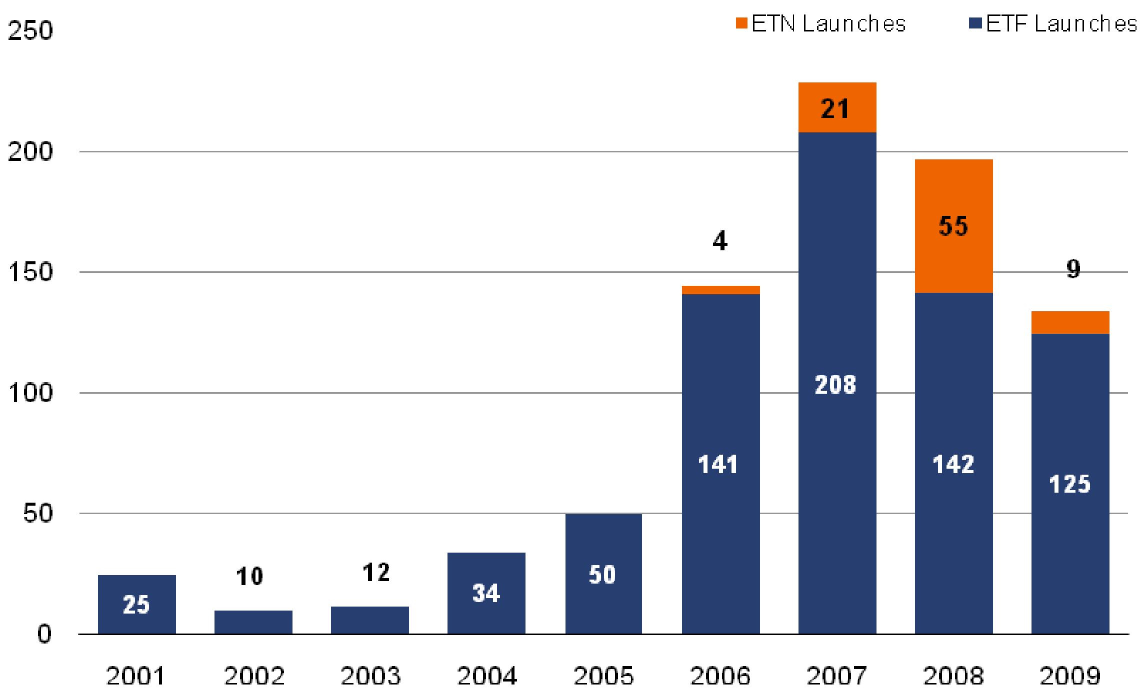
Early in 2010, Fidelity responded by partnering with BlackRock to offer 25 iShares ETFs with commission-free trading on the Fidelity platform. There's also been talk that Fidelity could launch its own brand of active ETFs, though the firm has made no formal filings.

We expect 2010 will see more firms join the ETF party. Other major fund companies that applied for exemptive relief in 2009 to launch ETFs include T. Rowe Price, Russell Investments, John Hancock, and Goldman Sachs.

We expect 2010 will see more firms join the ETF party. Other major fund companies that applied for exemptive relief in 2009 to launch ETFs include T. Rowe Price, Russell Investments, John Hancock, and Goldman Sachs.

### ETN Product Proliferation Takes a Breather

Only nine of the new fund launches in 2009 were ETNs. Albeit short-lived, the rapid growth of ETNs came to a screeching halt in the fourth quarter of 2008 as the financial crises led investors to adopt a strong aversion to credit risk. Prior to the credit crisis, ETNs seemed to be the next big thing as they allowed providers to offer exposure to many difficult-to-access asset classes and strategies that would be hard to achieve within the ETF structure.

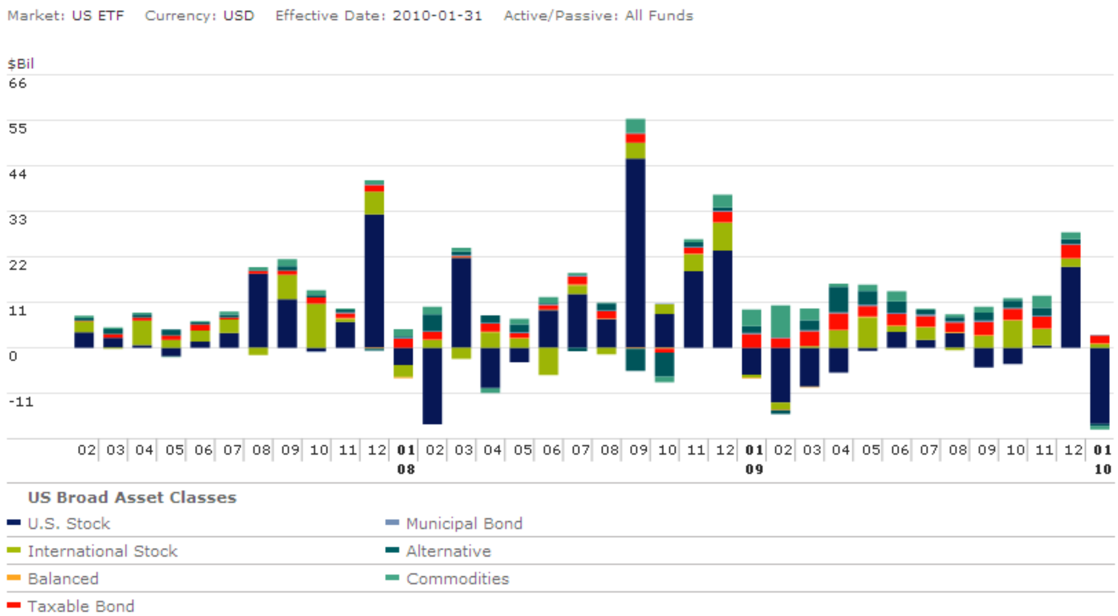



Source: Morningstar Direct

Barclays Capital, which retained the iPath ETN business after the BlackRock-BGI merger, was responsible for seven of the nine ETN launches in 2009 (none of which would be practical in the traditional ETF wrapper). Early in the year, the firm introduced investors to a brand new asset class with the launch of two volatility tracking notes. Despite volatility's steady decline throughout the year, the new ETNs were an instant success as investors seeking portfolio insurance loaded up on the funds. At the end of January 2010, the two ETNs had about $1.3 billion in assets (both ETNs launched on Jan. 29, 2009). The firm's other five new launches were leveraged ETNs based on the S&P 500 Index (two longs and three shorts). The new products offer a different take on "leverage," as they will not reset daily or monthly but will expire on a designated future date.

**Without SPY, U.S. Stock ETFs Would Have Shown Inflows in 2009**

U.S. stock ETFs saw more than $18 billion in outflows in 2009. However, outflows from SPDRs SPY reached $21 billion for the year. Excluding SPY, the asset class had roughly $6.2 billion in net *inflows*. Because of the fund's enormous size and volatile flows, it can be worth evaluating ETF flows/assets with and without the ubiquitous SPDRs. The chart below shows monthly ETF flows over the past three years.




Source: [Morningstar Direct Fund Flows]

The massive swings between net creations and net redemptions around calendar year-end are a phenomenon that goes back several years. Each year in the charts, note the large inflows in December followed by outflows in January. (The impact of SPY can be seen through the U.S. stock category in the chart above.) This trend is nothing new, but there is still no definite theory behind it. Still, it seems reasonable to hypothesize that as year-end approaches, portfolio managers might plow into the SPY in order to maintain market beta and capitalize on the fund's unrivaled liquidity.

Because of its size and ease of trading, SPY can also be an effective tool for portfolio managers handling large asset inflows. Rather than piling up cash while hunting for places to put capital to work, managers can "equitize" cash by owning SPY. Thanks to the massive volume of daily SPY shares traded, managers can comfortably move in and out of positions without having a market impact. After the books close for the year and managers start spotting opportunities, the outflows begin. A more cynical thesis for the year-end SPY flows would be that managers are "window-dressing" to avoid reporting large cash balances to clients.

**Emerging Markets Helped Drive Asset Growth for International Stock ETFs**

International equity ETFs posted a strong year in 2009, both in terms of performance and asset flows. Diversified emerging markets was the most popular category among international funds. We continued to see investors' cost-consciousness on display in the showdown between iShares MSCI Emerging Markets Index EEM and Vanguard Emerging Markets Stock ETF VWO. In 2009, VWO took in $9.0 billion in net new assets and ended the year with $19.5 billion in total assets, while EEM brought in approximately $4.4 billion and ended the year with $39.2 billion in assets. ETF industry followers are well aware of the discrepancy in expenses between the two funds. We'll be watching in 2010 to see if the gap in assets continues to narrow.

While the broader indexes grabbed headlines, several single-country ETFs were quietly amassing assets over the past year. In particular, we saw investors flock toward resource-rich countries such as iShares MSCI Brazil Index EWZ ($1.7 billion in total net inflows in 2009), iShares MSCI Australia Index EWA ($1.2 billion), iShares MSCI Canada Index EWC ($1.1 billion), and iShares MSCI Taiwan Index EWT ($1.1 billion).

In terms of product development, the international-stock asset class continues to see activity. The current trend is the slicing and dicing of global sectors. This includes funds like emerging-markets sector ETFs, single-country (ex-U.S.) sector funds, and regional sector funds (Far East, Eastern Europe, Australasia, and so on).

We also expect to see more frontier market funds introduced in the near future. Frontier markets have been one of the primary focuses of Van Eck's ETF business. However, recent filing activity from iShares indicates the industry's 800-pound gorilla might soon be adding to its suite of international-equity funds and encroaching on Van Eck's turf.

### Fixed-Income ETFs Were the Center of Attention in 2009

Investors flocked to bonds last year, and ETF providers responded to the voracious demand with new product launches. Fixed-income ETFs took in the most new assets of all the broad asset classes in 2009, despite finishing the year with only 77 ETFs--20 of which were muni-bond ETFs. (For comparison, there were about 450 U.S. stock ETFs and 170 international-stock ETFs in the same period.)

PIMCO's entrance into the ETF market should certainly help drive growth within the asset class. The firm launched nine bond ETFs in the second half of 2009 (two of which are actively managed). And in early February 2010, PIMCO ETFs already had more than $550 million in assets.

Aside from ETF newcomer PIMCO, it was the "old guard" that was behind the bond ETF product proliferation of 2009. Vanguard and SSgA introduced seven new bond ETFs each last year, and iShares launched four of its own.

### Investors Look to Commodity ETFs for Inflation Hedges

Commodity ETFs saw healthy inflows in 2009, led by SPDR Gold Shares GLD, which saw more than $11 billion in total net inflows in 2009 (the most for any individual ETF). The flows into GLD (which has $40 billion in assets) last year represented more than 42% of total flows into the commodity asset class.

Broad-based commodity funds based on rolling futures contracts also saw healthy inflows last year. However, as credit concerns tainted the ETN structure and contango tainted rolling futures strategies, investors increasingly favored physically backed commodity exposure. New providers, like Jeffries Asset Management, are trying to offer alternative solutions within commodity-producing equities as a result of investor backlash against contango.

European firm ETF Securities made its foray into the U.S. ETF market in 2009. The firm's physically backed gold and silver ETFs have amassed almost $500 million in assets. Early on in 2010 the company also introduced the first physically backed platinum and palladium ETFs to U.S. investors.

### Leveraged/Inverse ETF Flows Reveal Questionable Market-Timing Behavior

The year 2009 was an interesting one for leveraged and inverse ETFs. New funds are consistently being introduced, and the funds are regulars on the most active trading lists. Purveyors of these aggressive products vigorously defended the investment merits of leveraged ETFs in 2009, even as misconceptions about the funds caused FINRA to step in with a warning on behalf of investors in June. In addition, several financial advisory platforms placed restrictions on investing in the funds for client accounts.

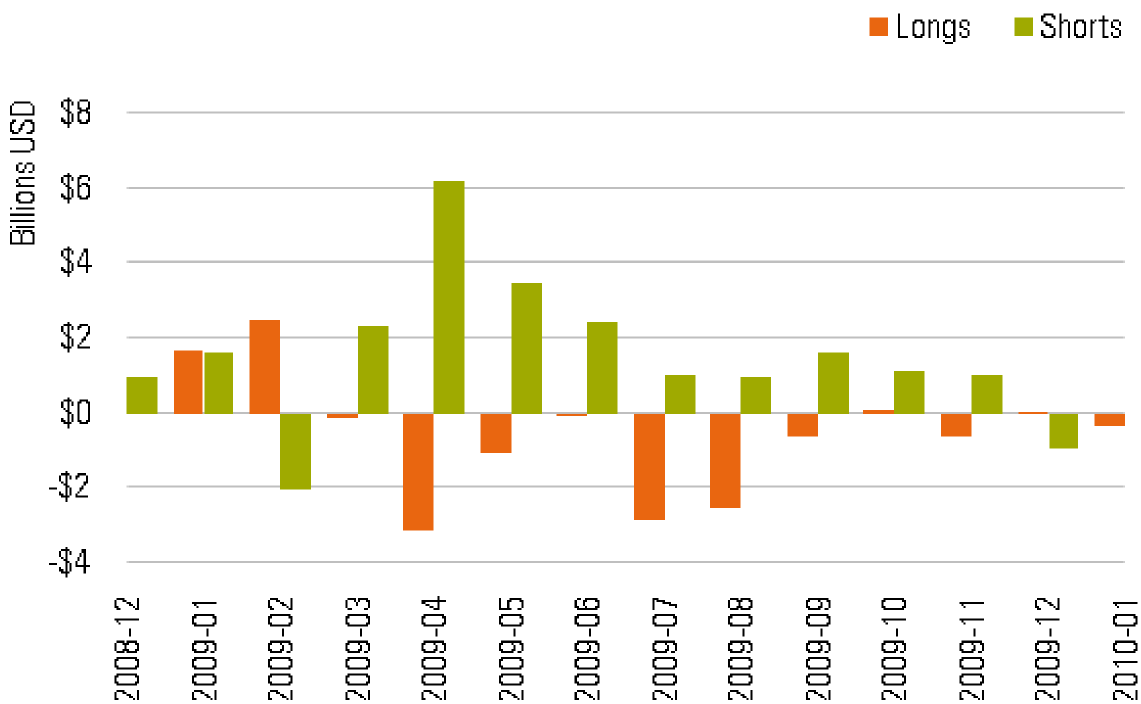
These vehicles are often used to try to time the market, a task that few can carry out effectively. The job is made even more difficult with sharp market swings like we've seen lately. A glance at the annual figures in the table below shows that investors heavily favored short exposure last year, but were pummeled as the market screamed higher. The outflows we saw for the long funds essentially amounted to profit-taking. However, it wasn't enough to offset the wealth destroyed in the short ETFs.

| | 12/31/2008 TNA ($Mil) | 2009 Est. Net Flows ($Mil) | 12/31/2009 TNA ($Mil) | Wealth Created ($Mil) |
|---|---|---|---|---|
| Short (-1x, -2x, -3x) | 10,763 | 18,895 | 18,858 | -10,809 |
| Long (2x, 3x) | 11,909 | -6,731 | 11,904 | 6,727 |
| Total | 22,672 | 12,160 | 30,749 | -4,082 |
| | # of ETFs | | # of ETFs | 2009 Launches |
| Short (-1x, -2x, -3x) | 73 | | 90 | 17 |
| Long (2x, 3x) | 49 | | 65 | 16 |
| Total | 122 | | 155 | 33 |

Source: Morningstar Direct Fund Flows

The questionable market-timing can be seen in the graph below. After the market bottomed in March, there was a huge spike in inflows to short ETFs and corresponding outflows for long ETFs. Because of the extreme turnover in leveraged ETFs, we should take the flow data for what it is: estimation. But judging from those estimates, it looks like investors might have been cutting their winners too early (long ETFs) and pouring money into their losers (short ETFs).

**Long/Short Leveraged ETF Flows, Monthly**




Source: Morningstar Direct Fund Flows

**About Morningstar Direct**

All of the data in this report was sourced from Morningstar Direct, our global institutional research platform. The Fund Flows feature within Direct offers estimated flows, AUM, and market share data for managed investments globally. For more information about Fund Flows, please contact Sylvester Flood at +1 312-696-6519 or Sylvester.Flood@Morningstar.com, or visit our product web page.