CHAPTER 3

US Mutual Funds

A mutual fund is an investment company that pools money from shareholders and invests in a portfolio of securities. In 2023, 116 million individual investors in 68.7 million US households owned mutual funds, relying on them to meet long-term personal financial objectives, such as preparing for retirement, education, or a home purchase. US households and institutions also use money market funds as cash management tools. Mutual funds, including money market funds, had net inflows of $292 billion in 2023, or 1.3 percent of year-end 2022 total net assets. Changing demographics, portfolio rebalancing, and investors' reactions to US and worldwide economic and financial conditions play important roles in determining how demand for specific types of mutual funds—and for mutual funds in general—evolves.

IN THIS CHAPTER

Overview of Mutual Fund Trends

With $25.5 trillion in total net assets, the US mutual fund industry remained the largest in the world at year-end 2023. The majority of US mutual fund net assets at year-end 2023 were in long-term mutual funds, with equity funds alone making up 52 percent of US mutual fund net assets. Money market funds were the second-largest category, with 23 percent of net assets. Bond funds (19 percent) and hybrid funds (6 percent) held the remainder.

Investor Demand for US Mutual Funds

A variety of factors influence investor demand for mutual funds, such as funds' ability to assist investors in achieving their investment objectives. For example, US households rely on equity, bond, and hybrid mutual funds to meet long-term personal financial objectives, such as preparing for retirement, saving for emergencies, or saving for education. US households, as well as businesses and other institutional investors, use money market funds as cash management tools because they provide a high degree of liquidity and access to prevailing short-term market yields.

Investor demand for mutual funds increased in 2023—driven by significant inflows into money market funds that more than offset outflows from long-term funds. Money market funds experienced strong demand as investors were attracted to the highest short-term yields in the more than 15 years. By contrast, equity mutual funds experienced outflows in 2023 (despite strong stock market returns), reflecting an ongoing shift to other products. Additionally, bond mutual funds experienced modest outflows, which may reflect investors shifting some of their bond fund positions into money market funds to mitigate interest rate risk amid substantial interest rate volatility.

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Monthly Trends in Mutual Fund Investing
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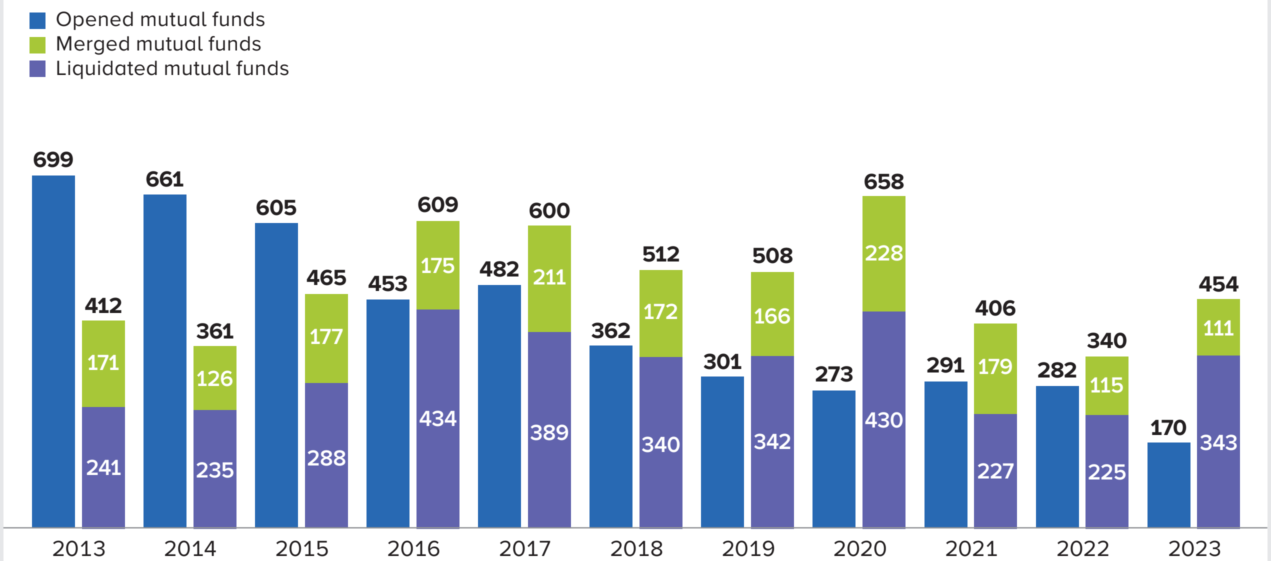
Entry and Exit of US Mutual Funds

Mutual fund sponsors create new funds to meet investor demand, and they merge or liquidate those that do not attract sufficient investor interest. A total of 170 mutual funds opened in 2023, down substantially from 2022 (Figure 3.1). This decline was driven primarily by a drop-off in the number of equity fund launches. During the same time, the number of mutual funds that were either merged or liquidated increased 34 percent to 454 funds as sponsors eliminated more equity mutual funds from their lineups.

FIGURE 3.1

Mutual Funds Enter and Exit the Industry Because of Competition and Investor Demand



Note: Data include mutual funds that do not report statistical information to the Investment Company Institute and mutual funds that invest primarily in other mutual funds.

Investors in US Mutual Funds

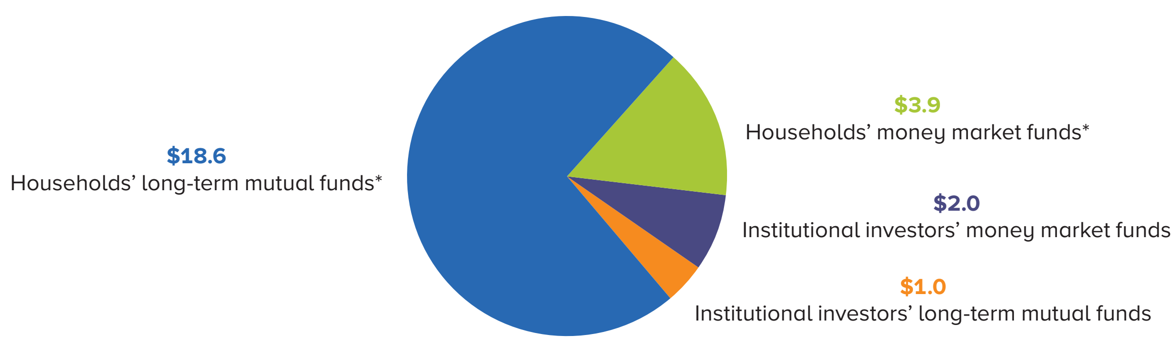
Demand for mutual funds is, in part, related to the types of investors who hold mutual fund shares. Retail investors (i.e., households) held the vast majority (88 percent) of the $25.5 trillion in US mutual fund total net assets at year-end 2023 (Figure 3.2). When looking at only long-term mutual funds, the share of net assets held by retail investors was even higher (95 percent). Retail investors also held substantial money market fund net assets ($3.9 trillion), but this was a relatively small share (18 percent) of their total mutual fund net assets ($22.5 trillion).

By contrast, institutional investors such as nonfinancial businesses, financial institutions, and nonprofit organizations held a relatively small portion of mutual fund net assets. At year-end 2023, institutions held 12 percent of mutual fund net assets (Figure 3.2). The majority (66 percent) of the $3.0 trillion that institutions held in mutual funds was in money market funds, because one of the primary reasons institutions use mutual funds is to help manage their cash balances.

FIGURE 3.2

Households Held 88 Percent of Mutual Fund Total Net Assets

Trillions of dollars, year-end 2023



Mutual fund total net assets: $25.5 trillion

Long-term mutual fund total net assets: $19.6 trillion

Money market fund total net assets: $5.9 trillion

* Mutual funds held as investments in individual retirement accounts, defined contribution retirement plans, variable annuities, 529 plans, and Coverdell education savings accounts are counted as household holdings of mutual funds.

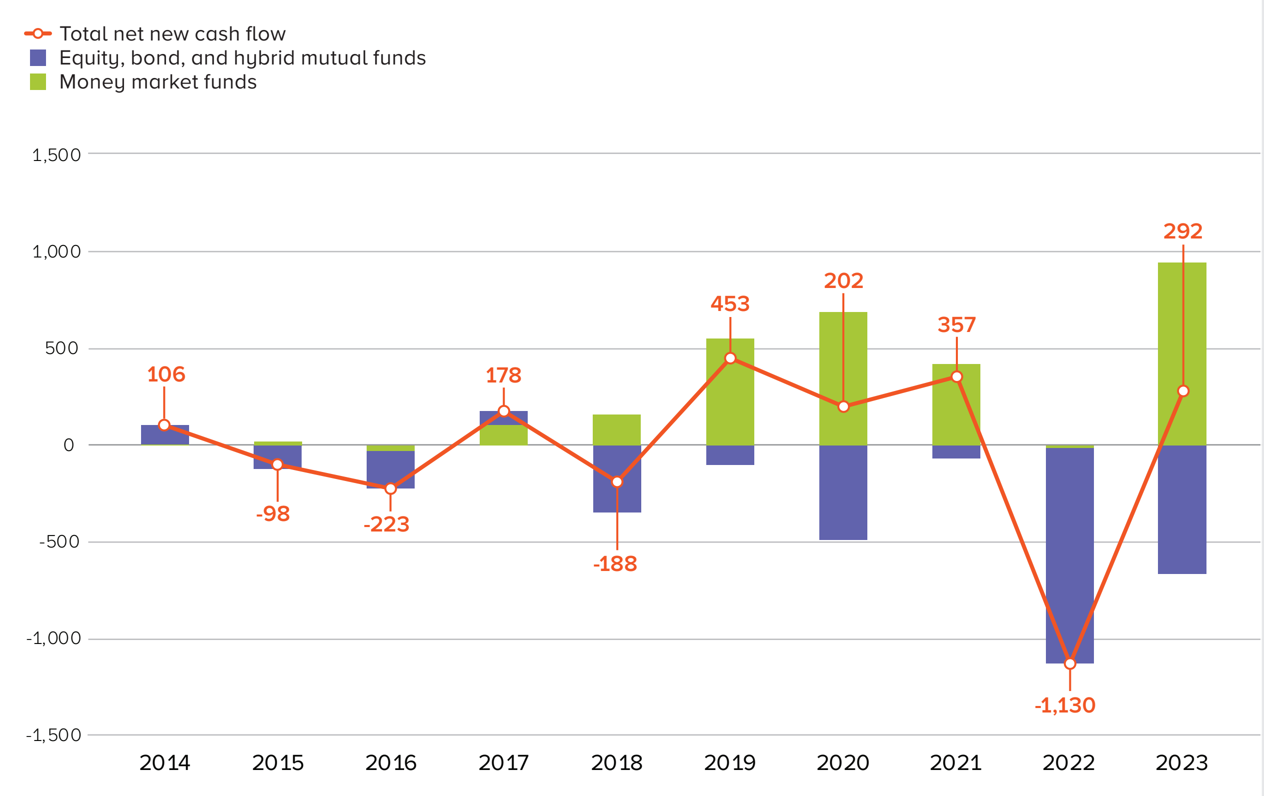
Developments in Mutual Fund Flows

Overall demand for mutual funds as measured by net new cash flow—new fund sales less redemptions, plus net exchanges—increased in 2023 (Figure 3.3). In 2023, mutual funds had net inflows of $292 billion (1.3 percent of year-end 2022 total net assets), following net outflows of $1.1 trillion in 2022. Long-term mutual funds experienced net outflows of $665 billion in 2023, while money market funds saw net inflows of $957 billion. A number of factors—including rising short-term interest rates, ongoing demographic trends, and demand for indexed products—appeared to influence US mutual fund flows in 2023.

FIGURE 3.3

Inflows to Money Market Funds More Than Offset Outflows from Long-Term Mutual Funds in 2023

Billions of dollars, annual



The US Economy and Financial Markets in 2023

Despite continued monetary tightening by the Federal Reserve and periods of heightened uncertainty, 2023 proved to be a strong year for the US economy and financial markets. The US economy grew at a robust 2.5 percent rate in 2023, defying concerns of a widely anticipated recession. Strong consumer spending and steady job creation fueled this economic growth. In 2023, consumer spending (adjusted for inflation) expanded by 2.2 percent. Additionally, the economy added 3 million jobs while the unemployment rate remained below 4 percent (despite a modest increase during the year).

Another positive development for the economy was a significant decline in the inflation rate in 2023. Inflation eased substantially from 6.5 percent in 2022 to 3.4 percent in 2023 as the Federal Reserve continued its monetary tightening—raising the federal funds rate by 1 percentage point over four 25-basis-point rate hikes to end the year at a target range of 5.25 to 5.50 percent.

The moderation in inflation boosted investor confidence that the Federal Reserve would reduce interest rates in the near future, which fueled a surge in US stock markets and resulted in a 26.1 percent total return in 2023.* Bond market performance generally struggled for most of the year as interest rate volatility persisted. At year-end, however, bond markets staged a strong comeback with total returns (capital gains and interest income) of 7.7 percent in November and December alone and 5.8 percent for the full year.†

Long-Term Mutual Fund Flows

Although net new cash flows into long-term mutual funds are typically correlated with market returns, they tend to be moderate as a percentage of total net assets even during episodes of market turmoil. Several factors may contribute to this phenomenon. For example, households (i.e., retail investors) own the vast majority of US long-term mutual fund net assets (Figure 3.2). Retail investors generally respond less strongly to market events than do institutional investors. Most notably, households often use mutual funds to save for the long term, such as for college or retirement. Many of these investors make stable contributions through periodic payroll deductions, even during periods of market stress. In addition, many mutual fund shareholders seek the advice of financial advisers, who may provide a steadying influence during market downturns. These factors are amplified by the fact that net assets in mutual funds are spread across 116 million investors who have a wide variety of individual characteristics (such as age or appetite for risk) and goals (such as saving for retirement, emergencies, or education). Investors are also bound to have a wide range of views on market conditions and how best to respond to those conditions to meet their individual goals. As a result, even during months when funds as a whole experience net outflows, many investors continue to purchase fund shares.

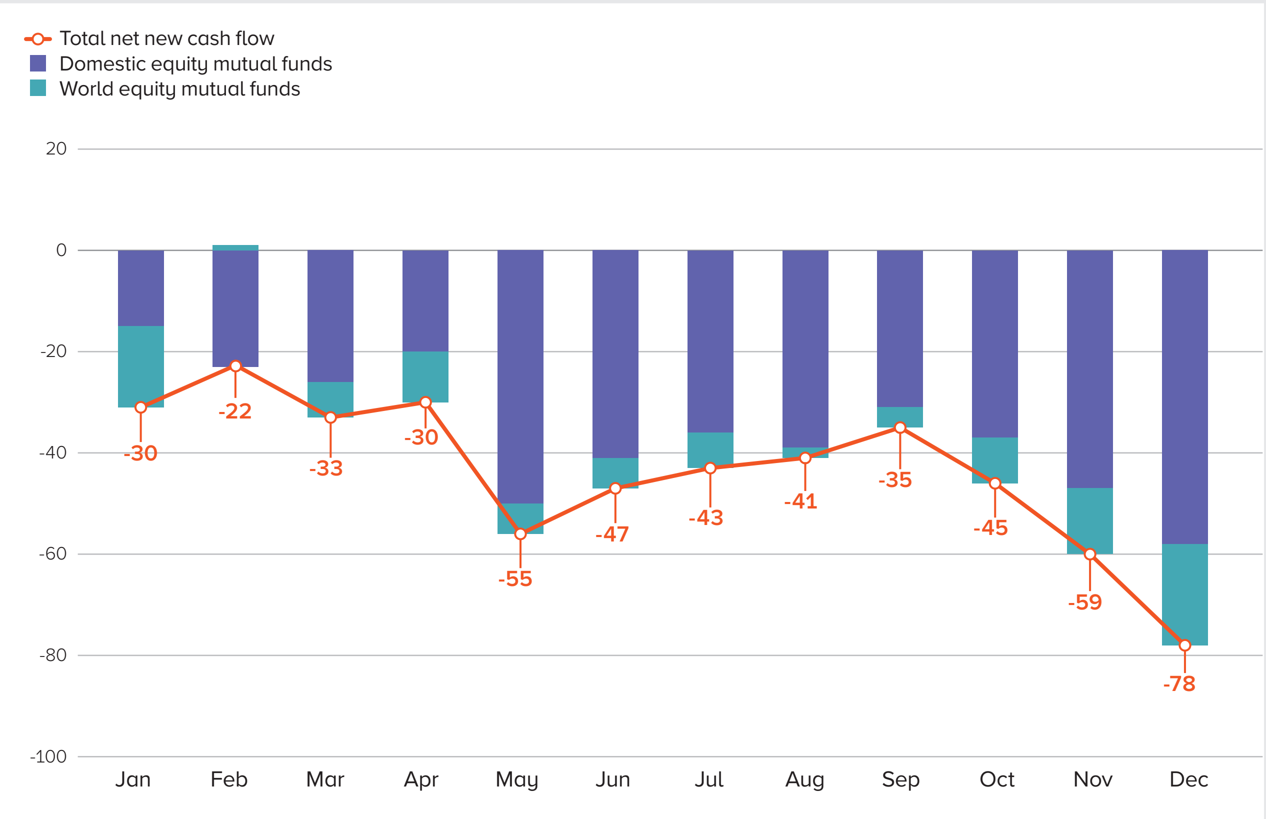
* As measured by the Wilshire 5000 Total Market Index.

† As measured by the S&P US Aggregate Bond Index.

Equity Mutual Funds

Equity mutual funds experienced net outflows every month in 2023, totaling $518 billion over the year or 4.6 percent of year-end 2022 total net assets (Figure 3.4). In the first three months of the year, investors had redeemed, on net, a modest $85 billion from equity mutual funds. Flows to mutual funds, in general, tend to be bolstered in the first quarter of the year because investors who receive year-end bonuses may invest that money relatively quickly in the new year. In addition, some investors wait to make contributions to their individual retirement accounts (IRAs) before filing their tax returns. As the year progressed, net outflows from equity mutual funds accelerated, with investors redeeming, on net, $433 billion from April through December.

FIGURE 3.4
Equity Mutual Funds Experienced Net Outflows Throughout 2023
Billions of dollars; monthly, 2023



From December Outflows to January Inflows: Seasonal Factors in Mutual Fund Flows
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Net outflows from equity mutual funds in 2023 were likely driven by continued investor demand for equity exchange-traded funds (ETFs). As discussed in chapter 4, demand for ETFs has been very strong over the past several years. Except for February, equity ETFs had net creations in every month of 2023, which resulted in $402 billion in net share issuance over the year (see Figure 4.4). By contrast, equity mutual funds had net outflows of $518 billion in 2023 (Figure 3.4).

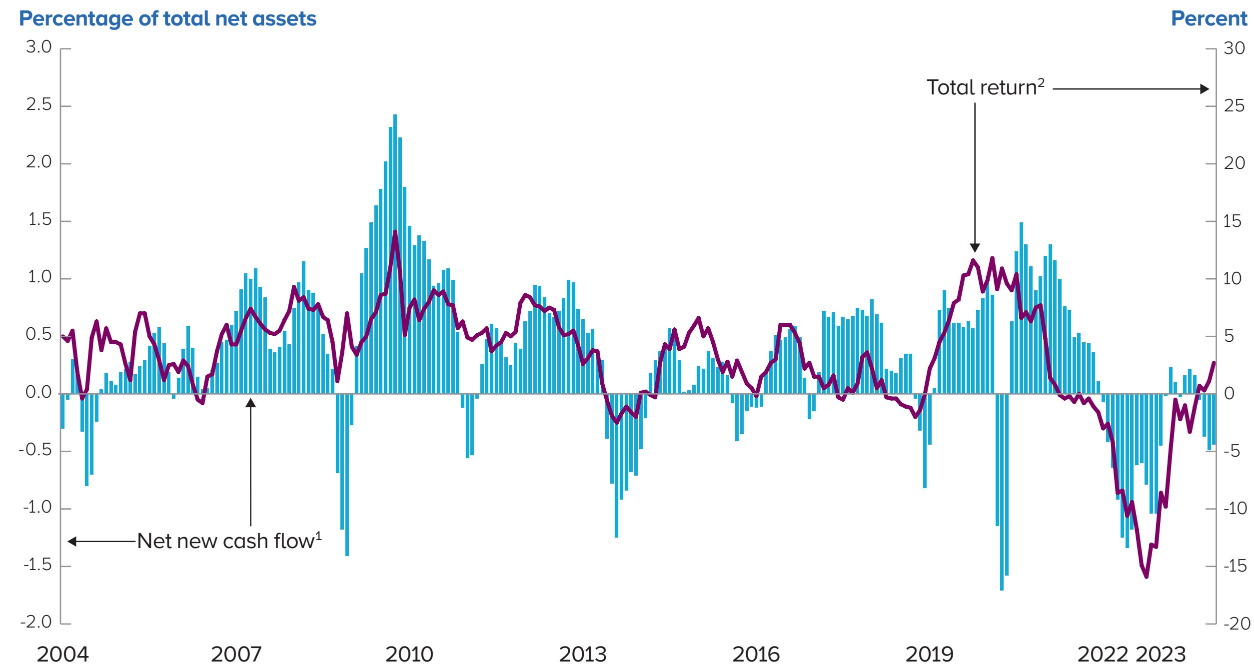
Bond Mutual Funds

Bond mutual fund net new cash flows typically are correlated with the performance of US bonds (Figure 3.5), which, in turn, is largely driven by the US interest rate environment. In 2023, bond mutual funds faced significant interest rate volatility as long-term interest rates fluctuated widely throughout the year despite ending the year exactly where they started. The yield on the 10-year Treasury started 2023 at 3.9 percent, dropped to as low as 3.3 percent in early April following the regional banking crisis in March, but then reached 5.0 percent in October (its highest level since mid-2007) before retreating to 3.9 percent at year-end.

FIGURE 3.5

Net New Cash Flow to Bond Mutual Funds Is Typically Related to Bond Returns

Monthly



[1] Net new cash flow is reported as a percentage of previous month-end bond mutual fund total net assets, plotted as a three-month moving average. Data exclude high-yield bond mutual funds.

[2] The total return on bonds is measured as the year-over-year percent change in the FTSE US Broad Investment Grade Bond Index.

Sources: Investment Company Institute, FTSE Russell, and Refinitiv

Taxable bond mutual funds experienced modest outflows totaling $18 billion in 2023, or 0.5 percent of their year-end 2022 total net assets (Figure 3.6). These net outflows were far lower than the $394 billion in outflows in 2022 which were likely prompted by the double-digit losses seen in the bond market that year. In addition to a sharp reversal in the performance of US bonds in 2023, portfolio rebalancing may have contributed to the significant reduction in taxable bond mutual fund outflows. With stocks significantly outperforming bonds in 2023, investors and target date funds following asset allocation strategies would have needed to buy bond funds and sell equity funds to remain at their target allocations. Nonetheless, outflows from bond mutual funds persisted, as investors may have reallocated some of their bond fund holdings into money market funds to reduce interest rate risk.

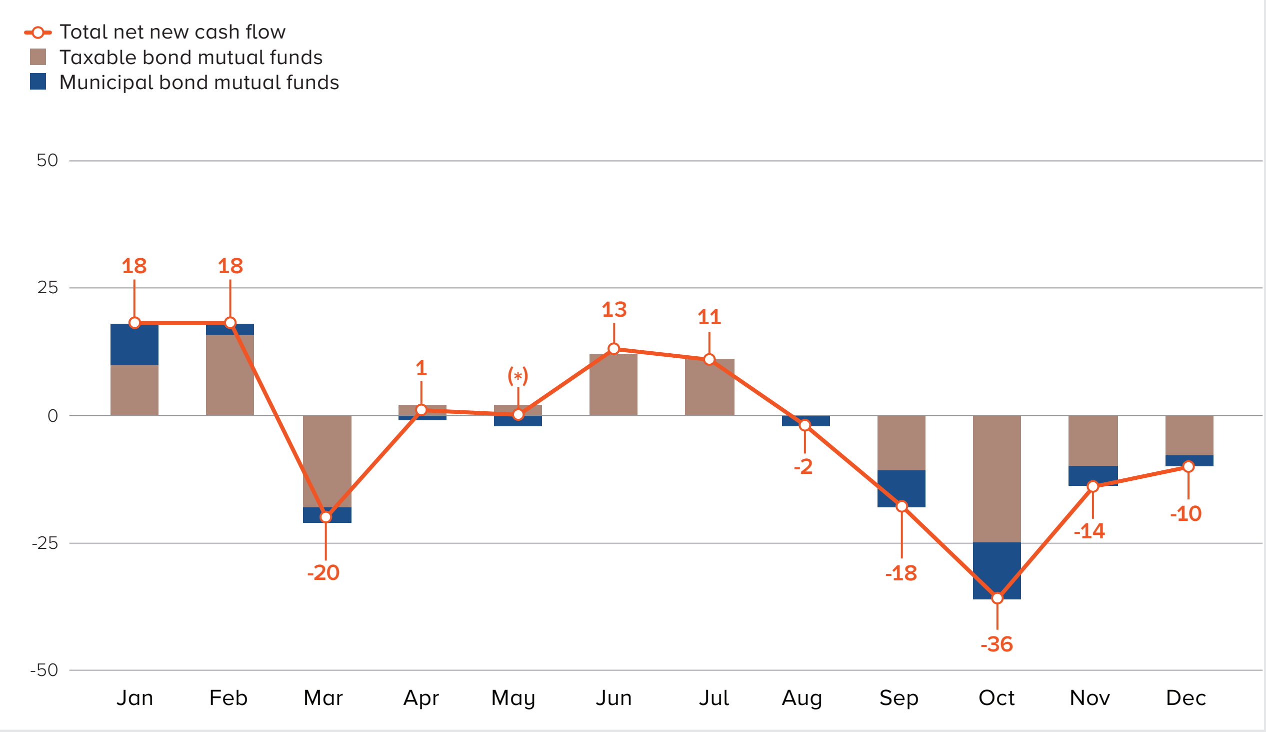
Most categories of taxable bond mutual funds experienced outflows in 2023, with high-yield bond funds experiencing the bulk of outflows—$26 billion, which represented 8.4 percent of their year-end 2022 total net assets. World bond funds, which typically hold a mix of bonds denominated in US dollars and foreign currencies, saw net outflows of $9 billion (2.0 percent); investment grade bond funds saw net outflows of $5 billion (0.2 percent); and government bond funds saw net outflows of $3 billion (0.8 percent). By contrast, multi-sector bond funds saw inflows of $25 billion (or 5.0 percent of their net assets at year-end 2022).

Municipal bond mutual funds also experienced outflows in 2023, with net outflows totaling $20 billion for the year, or 2.7 percent of their year-end 2022 net assets.

FIGURE 3.6

Net New Cash Flow to Bond Mutual Funds Fluctuated Throughout 2023

Billions of dollars; monthly, 2023



(*) = inflow or outflow of less than $500 million

How Bond Mutual Funds Manage Investor Flows

When meeting redemptions, fund managers' actions are guided by market conditions, expected investor flows, and other factors. A fund might decide to sell some of its holdings to raise the cash needed to fulfill redemptions. But its choice of which particular securities to sell may depend on market conditions. For example, during a market downturn, with liquidity at a premium, some fund managers might seek to add shareholder value by selling some of their funds' more-liquid bonds (which, being in high demand, are trading at a premium to fundamental value). Other fund managers may conclude that it is necessary and appropriate to sell a representative "slice" of their funds' entire portfolios.

Bond mutual fund managers have other ways of meeting redemption requests. For example, a fund might already have cash on hand. Or, the fund may use the cash that bond mutual funds receive each day in the form of interest income from bonds held in the portfolio, proceeds from matured bonds, or new sales of fund shares.

In addition, bond funds often use derivatives or hold liquid assets other than cash. For example, a high-yield bond fund might hold some portion of its assets in equities because equities are very liquid and the return profiles of high-yield bonds and equities can be similar. Derivatives can be more liquid than their physical counterparts, and funds are required to segregate liquid assets to support their derivatives positions. As these positions are closed, this cash collateral provides a ready source of liquidity to meet redemptions. This is especially true for many of the funds commonly called liquid alternative funds, as these funds are explicitly designed to allow frequent investor trading and do so in large measure through the use of derivatives.

Long-Term Demand for Bond Mutual Funds

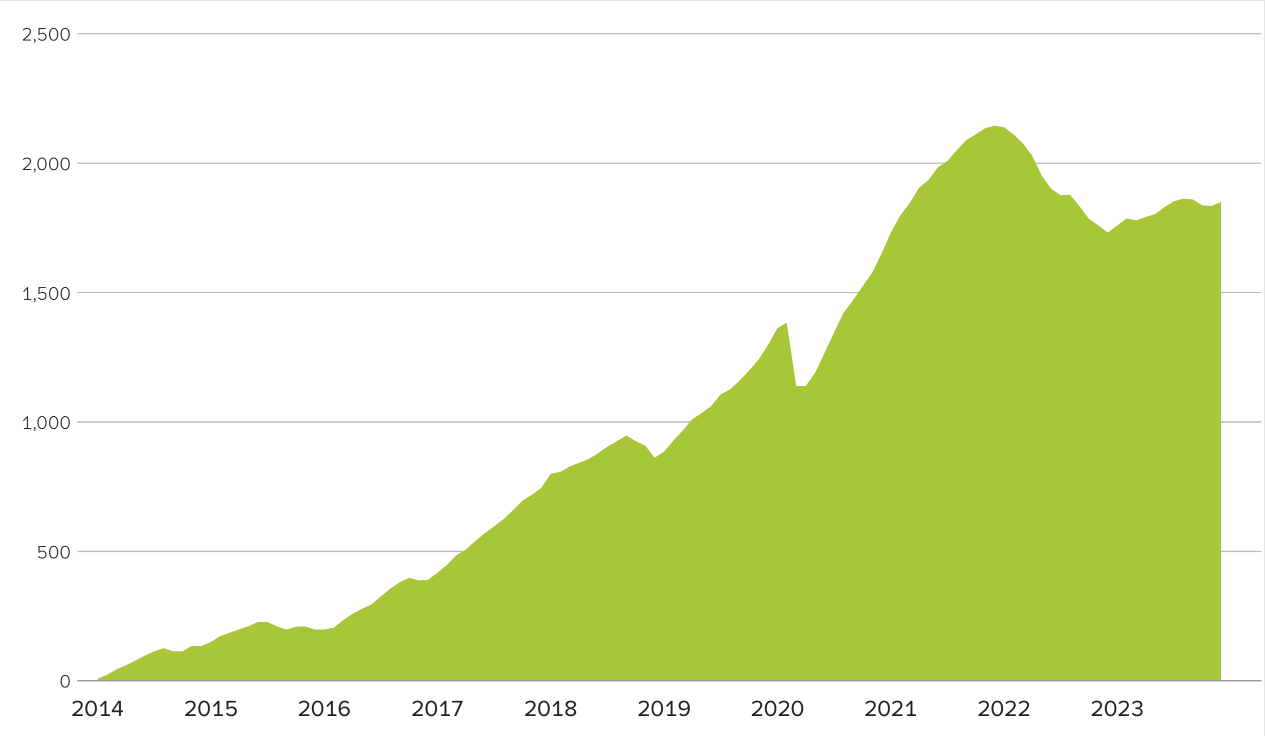
Despite outflows in 2023, bond mutual funds have received $1.85 trillion in net new cash flow and reinvested dividends in the past decade (Figure 3.7).

A number of factors have helped contribute to this long-term demand for bond mutual funds, including demographics. Older investors tend to have larger account balances because they have had more time to accumulate savings and take advantage of compounding. At the same time, as investors age, they tend to shift toward fixed-income products. Over the past decade, the aging US population has boosted flows to bond funds.

FIGURE 3.7

Bond Mutual Funds Have Experienced Net Inflows Through Most of the Past Decade

Cumulative flows to bond mutual funds, billions of dollars, monthly



Note: Bond mutual fund data include net new cash flow and reinvested dividends.

The popularity of target date mutual funds has also contributed to strong demand for bond mutual funds during this period. Target date funds invest in a changing mix of equities and fixed-income investments. As the fund approaches and passes its target date (which is usually specified in the fund's name), the fund gradually reallocates assets from equities to fixed-income investments, including bonds. Over the past 10 years, target date mutual funds have received net inflows of $372 billion. By year-end 2023, target date mutual funds had total net assets of $1.8 trillion. Investor interest in these funds likely reflects their automatic rebalancing features as well as their inclusion as an investment option in many defined contribution (DC) plans (see Figure 8.10).

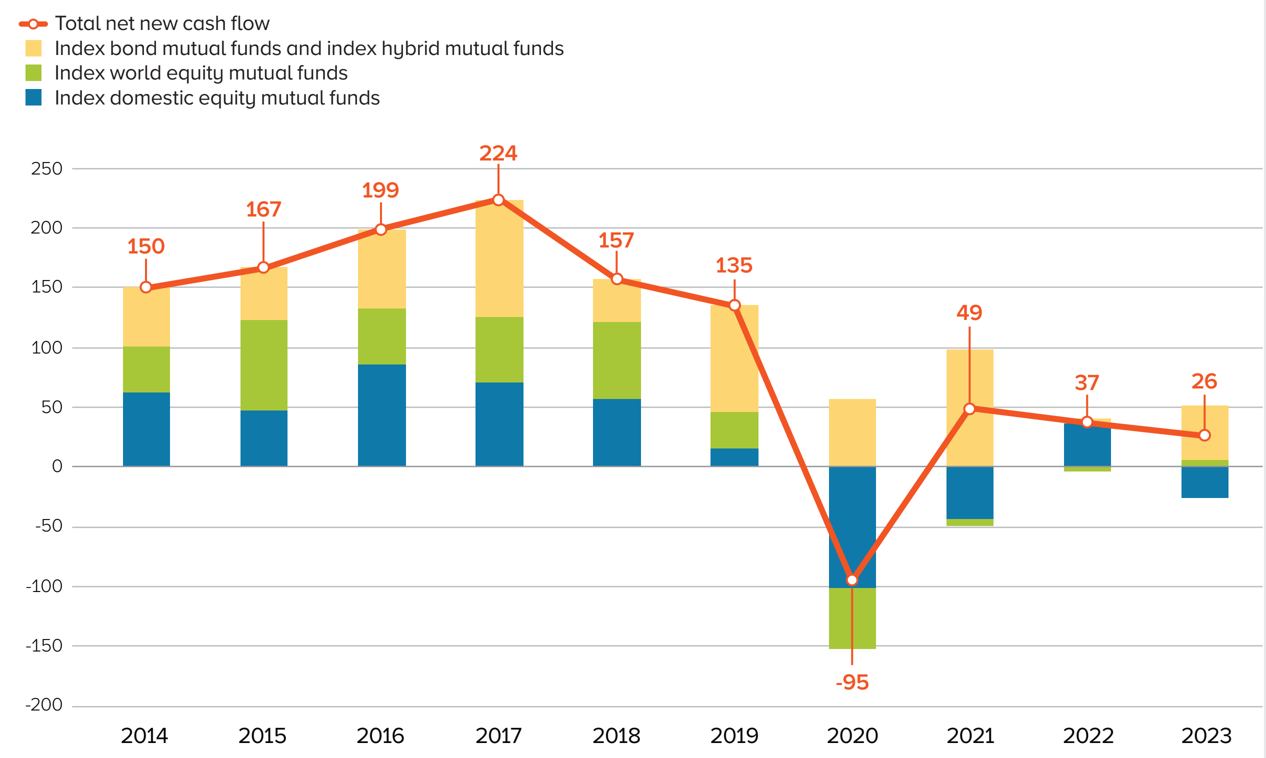
These long-term factors, combined with mostly positive annual returns on bonds and inflows from portfolio allocation strategies, have caused bond mutual fund total net assets to increase from $3.3 trillion at year-end 2013 to $4.7 trillion at year-end 2023. However, long-term mutual funds' share of US bond markets—most of which is held by bond mutual funds—has stayed relatively stable in recent years (see Figure 2.4).

Growth of Other Investment Products

Outflows from some long-term mutual funds over the past decade reflect a broader shift, driven by both investors and retirement plan sponsors, toward other pooled investment vehicles. This trend is reflected in the outflows from actively managed mutual funds and the growth of index mutual funds, ETFs, and collective investment trusts (CITs) since 2007.

Index mutual funds—which hold all (or a representative sample) of the securities in a specified index—are popular among investors. Of households that owned mutual funds, 46 percent owned at least one index equity mutual fund in 2023. As of year-end 2023, 516 index mutual funds managed total net assets of $5.9 trillion. For 2023 as a whole, investors added $26 billion in net new cash flow to these funds (Figure 3.8). Outflows from index domestic equity mutual funds ($26 billion) were more than offset by inflows into index bond and hybrid mutual funds and index world equity mutual funds ($46 billion and $6 billion, respectively).

FIGURE 3.8
Index Mutual Funds Saw Net Inflows in 2023
Billions of dollars, annual

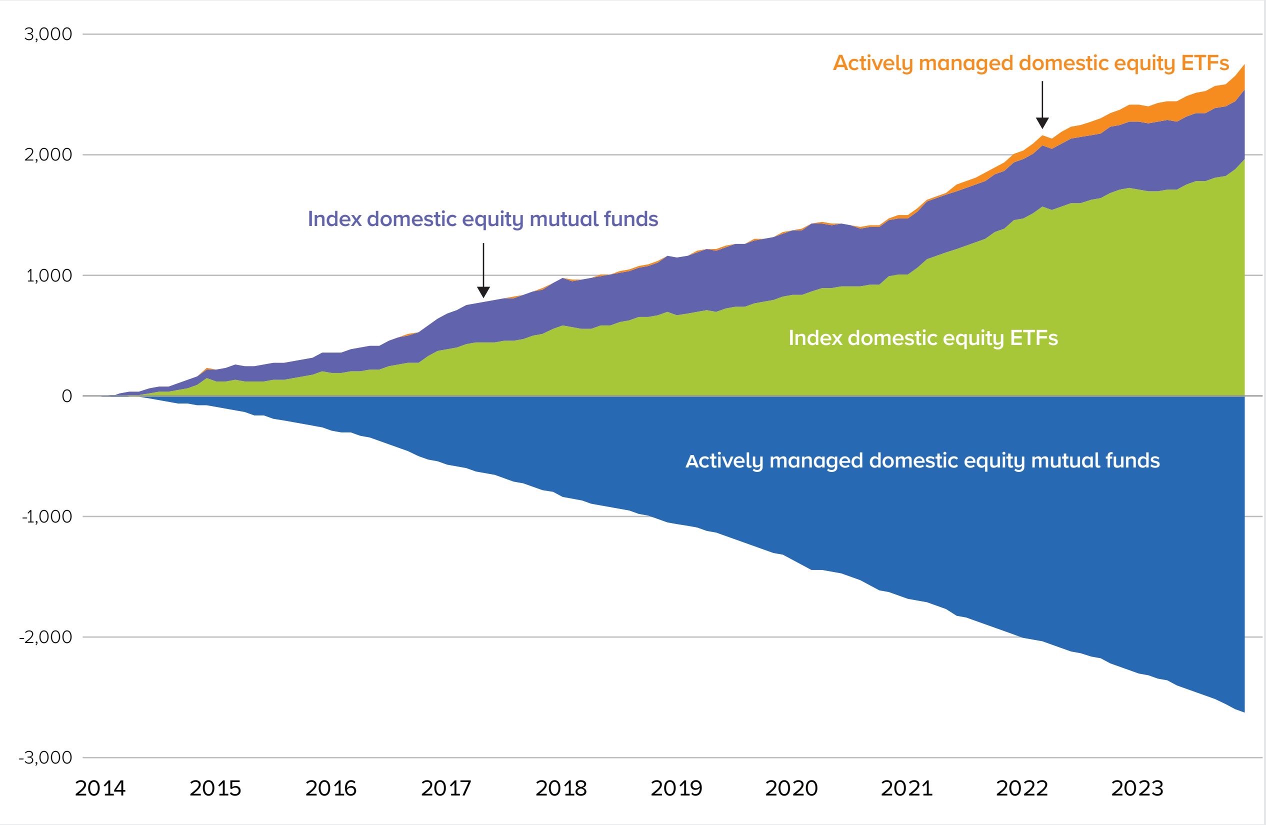


Index domestic equity mutual funds and ETFs have particularly benefited from the overall increase in investor demand for index-based investment products. From 2014 through 2023, index domestic equity mutual funds and ETFs received $2.5 trillion in net new cash and reinvested dividends, while actively managed domestic equity mutual funds experienced net outflows of $2.6 trillion (including reinvested dividends) (Figure 3.9). Index domestic equity ETFs have grown rapidly—attracting more than three times the amount of net inflows of index domestic equity mutual funds since 2014. Part of the increasing popularity of ETFs in the past decade is attributable to more brokers and financial advisers using them in their clients' portfolios. In 2022, full-service brokers and fee-based advisers had 32 percent and 45 percent, respectively, of their clients' household assets invested in ETFs, up sharply from 6 percent and 14 percent in 2012 (Figure 3.10).

FIGURE 3.9

Some of the Outflows from Domestic Equity Mutual Funds Have Gone to ETFs

Cumulative flows to domestic equity mutual funds and net share issuance of domestic equity ETFs, billions of dollars, monthly

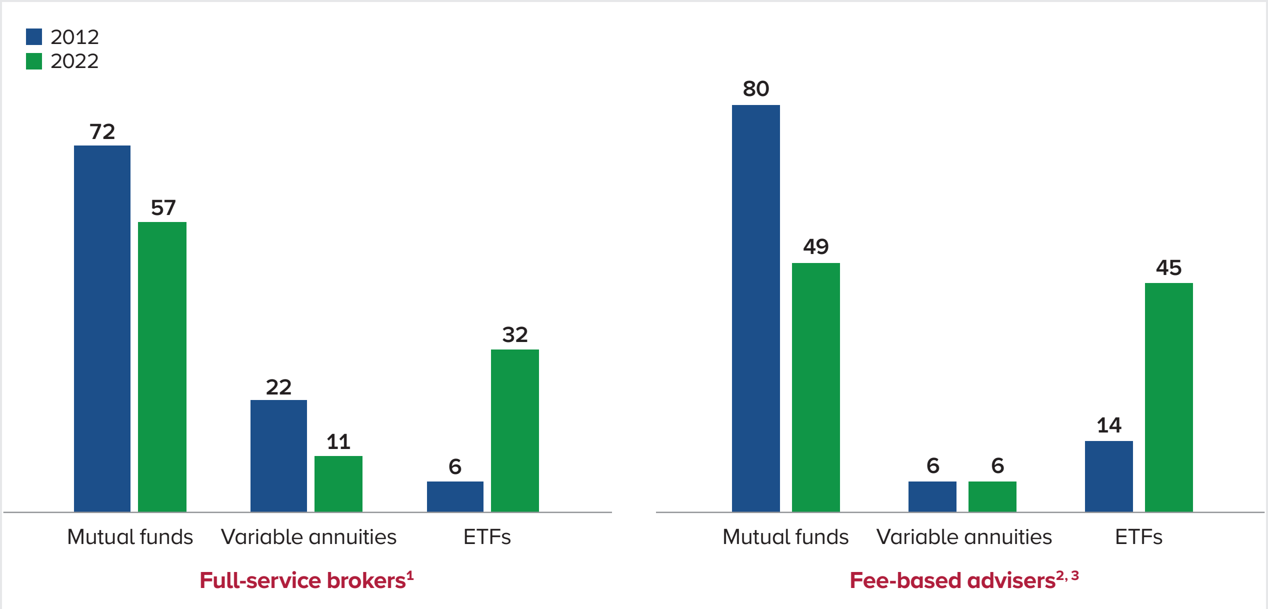


Note: Mutual fund data include net new cash flow and reinvested dividends; ETF data for net share issuance include reinvested dividends.

FIGURE 3.10

Fee-Based Advisers Are Investing Larger Portions of Client Portfolios in ETFs

Percentage of household assets invested in investment category by adviser type



[1] This category includes wirehouses as well as regional, independent, and bank broker-dealers.

[2] This category includes registered investment advisers and dually registered investment adviser broker-dealers.

[3] This category excludes an unknown portion of assets from investors who received fee-based advice but implemented trades themselves through discount brokers and fund supermarkets.

Note: In this figure, household assets include household holdings of mutual funds, variable annuities, and ETFs.

Source: Cerulli Associates, "The State of US Retail and Institutional Asset Management, 2023"

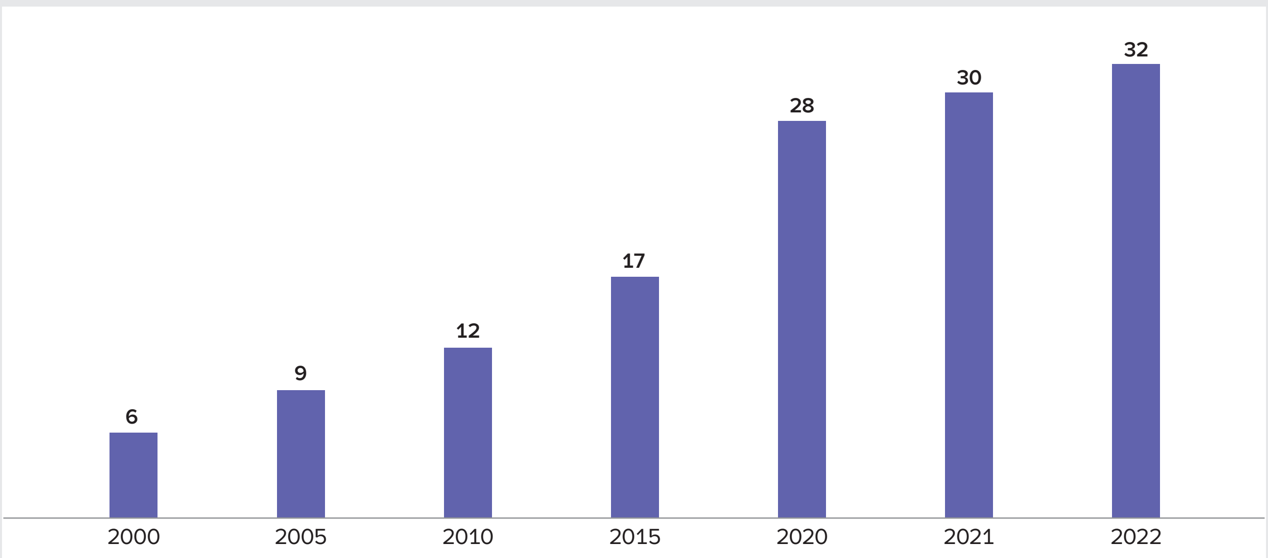
CITs are an alternative to mutual funds for DC plans. Like mutual funds, CITs pool the assets of investors and (either actively or passively) invest those assets according to a particular strategy. Much like institutional share classes of mutual funds, CITs generally require substantial minimum investment thresholds, which can limit the costs of managing pooled investment products. Unlike mutual funds, which are regulated under the Investment Company Act of 1940, CITs are regulated under banking laws and are not marketed as widely as mutual funds; this can also reduce their operational and compliance costs as compared with mutual funds.

More retirement plan sponsors have begun offering CITs as options in 401(k) plan lineups. As Figure 3.11 demonstrates, this trend has translated into a growing share of assets held in CITs by large 401(k) plans. That share increased from 6 percent in 2000 to an estimated 32 percent in 2022. This recent expansion is due, in part, to the growth in target date CITs.

FIGURE 3.11

Assets of Large 401(k) Plans Are Increasingly Held in Collective Investment Trusts

Percentage of assets in large 401(k) plans*



* Large 401(k) plans are those that filed Form 5500 Schedule H (typically plans with 100 participants or more).

Note: Assets exclude Direct Filing Entity assets that are reinvested in collective investment trusts. Data prior to 2022 come from the Form 5500 Research data sets released by the Department of Labor. Data for 2022 are preliminary, based on Department of Labor Form 5500 latest data sets.

Source: Investment Company Institute calculations of Department of Labor Form 5500 data

Money Market Funds

In 2023, money market funds saw substantial inflows of $957 billion—a significant reversal from outflows of $13 billion in 2022 (Figure 3.12). Government money market funds experiencing the bulk of inflows ($700 billion), while prime money market funds and tax-exempt money market funds saw inflows of $249 billion and $8 billion, respectively.

Robust demand for money market funds was particularly pronounced in March 2023, when investors rushed to these funds in response to the regional banking crisis, which began with the failure of Silicon Valley Bank. Money market funds continued to experience strong demand at various times during the rest of the year. Investors were drawn to the elevated market yields and low interest rate risk that these funds offered, especially in light of persistently high interest rate volatility in the bond markets during this time. To manage interest rate risk and shorten the duration of their fixed-income investments, some investors may have strategically reallocated a portion of their bond fund investments into money market funds.

FIGURE 3.12

Money Market Funds Experienced Strong Demand in 2023

Billions of dollars; monthly, 2023