Where has the Retail Investor Gone?

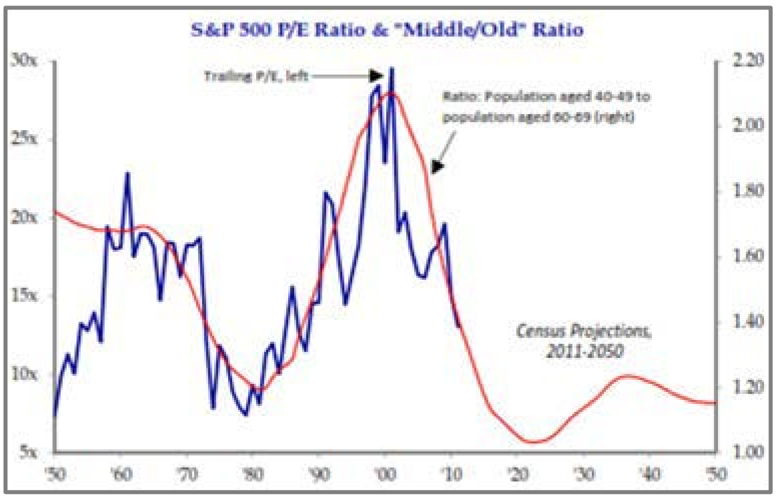
The goal of the MAI Insights platform is to provide you with our views on the most pressing issues and opportunities in the current investment environment. Despite the S&P 500's strong rebound from the March 2009 bottom through May 2012, investment flows over the same period have indicated a surprising flight from equities to bonds by retail investors. In the following discussion, we will provide the evidence for this phenomenon, uncover the reasons for it, and offer some alternative ways to satisfy investor appetite for return at what we believe are lower risk levels than traditional approaches to equities.

What can we learn from fund flows?

Regardless of what you believe about the quality and sustainability of the recovery since 2009, the market's advance has been impressive to say the least. In some cases, however, we would argue that the actual investor experience has been less positive based on the steady migration of investors toward lower risk assets at all stages of the rally. In fact, since 2008, retail investors have redeemed $411 billion from domestic equity mutual funds (a 9% decrease from 2008 asset levels) and added $837 billion to bond funds (a 38% increase over 2008 asset levels). In addition, bond fund flows have exceeded equity fund flows in all but four quarters since March 2008. The pronounced shift away from equities and into bonds during the course of a multi-year rally is very unusual and thus, it merits some attention to determine why it has taken place.

Why are equities so unloved?

Among the many plausible explanations for the exodus from equities, we believe it comes down to two main factors: the lost decade of the 2000s and the aging population's search for stability and income. Between the tech bubble of 2000-2001 and the financial crisis of 2008-2009, equity investors were burned twice in a short period of time. In fact, the average annual total return of large cap stocks in the 2000s was a miserable -0.9% while the average annual total return in long-term government bonds was a positive 7.7%. With their recent move into bonds, it seems likely that the retail investor is once again chasing performance after a volatile decade in equities left them with nothing to show for it. The second, more worrisome trend is the growing number of baby boomers nearing their retirement years that can no longer handle the volatility in the stock market and need their portfolios to generate income. According to the U.S. Census Bureau, the two fastest growing segments of the U.S. population from 2000-2010 were the age groups of 45 to 64 years and 65 years and over, which grew 31.5% and 15.1%, respectively. On the other hand, the age group of 25-44 years, which would typically represent the ideal age group for equity buyers, declined by 3.4% during the 10-year period. The U.S. Census Bureau is forecasting that growth in the 60-69 age group (bond buyers) will continue to outpace growth in the 40-49 age group (equity buyers) until at least 2020. As shown in the chart below from Strategas Research, a declining middle/old population ratio has historically been associated with declining market multiple. If the census forecasts are correct, this could be a multi-year headwind for equities.



Do bonds deserve to be this loved?

Given our middling outlook for the equity markets, we would not argue strongly against the more conservative stance taken by the retail investor. We would, however, question whether bonds are truly the best alternative to equities today. Thanks, in large part, to the unprecedented easing measures from the Federal Reserve, interest rates have fallen to historic lows. This is great news if you are a borrower; but not such good news if you are a bond investor. In most cases, bond investors now need to extend to 10 years for just 2% return! At these levels, bonds look relatively unattractive from a value standpoint versus other asset classes. This is not to say that bonds have given up their critical role within an asset allocation, but at the margin, it seems prudent to consider alternative ways to generate income.

Where do we see the opportunities today?

With the outlook for equities under pressure and interest rates at all-time lows, we have identified three parts of the market that offer attractive risk/ reward profiles as well as the opportunity to generate extra income: dividend-paying stocks, energy MLPs, and fixed-to-float preferred securities.

- **Dividend-Paying Stocks**: With the 10-year treasury rate languishing near 1.6%, we believe that high-quality multinational companies with dividend yields in the 2-4% range provide a more compelling long-term investment opportunity than bonds. We are focused on companies that have proven track records of not only paying a dividend, but growing it meaningfully over time, and have strong business outlooks to support continued dividend growth and price appreciation.
- **Energy MLPs**: Energy MLPs are companies that gather, process, transport, and store natural gas, natural gas liquids, crude oil, and other petroleum-based products. They are currently paying 5-6% annual distributions to shareholders and are expected to grow distributions 7-8% for the next several years. With stable, primarily fee-based businesses and a long runway of energy infrastructure build out ahead; the risk/reward opportunity in MLPs appears to be very attractive.
- **Fixed-to Float Preferred Securities**: Fixed-to-float preferred securities are hybrid investments issued primarily by financial companies, utilities, and MLPs, that pay a fixed dividend, currently yielding 5-7%, until a defined call date (typically 10 years after issuance), and then pay a floating dividend based on a certain spread over LIBOR (typically a 3-5% spread over LIBOR) if they are not called. We like these securities for their high current yield and the built-in protection against higher interest rates in the future.

We believe that all three of these areas provide a compelling value proposition and should perform relatively well in a low growth / low return market environment.

Sources:

1. JP Morgan Asset Management

2. Strategas Research Partners

3. U.S. Census Bureau

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MAI's preferred security strategy has a significant concentration in the financial sector that may have risks not present in a more diversified portfolio including shifting federal regulatory treatment of banks' financial capital that could make it attractive for banks to call preferred securities rather than pay income to holders of their preferred securities. MAI's Energy MLP Strategy is a concentrated energy sector portfolio that may have risks, including federal tax policy risks not present in a more diversified portfolio.