Domestic Credit by Steve Parsons

Stock mutuals boom underscores crisis

The surge in stock mutual funds is pumping up the bubble at the expense of small investors and real investment.

In the 16 months since the Federal Reserve began slashing interest rates, investments in stock mutual funds have been spiraling upward at record rates. Since December 1990, when the discount rate stood at 7%, stock mutual fund investments have gone from $245.8 billion to $393.7 billion today. That's an incredible 60% increase, beyond even the spectacular growth rates of the go-go 1980s.

Record net investment inflows have been set every other month recently. New records were set in December, February, and April, culminating in a $7.5 billion net inflow in April. What is even more amazing, at least on first impression, is that these new record inflows have occurred while the average stock fund has *lost* nearly 1% of its value this year.

The financial press reports that even investment managers are supposedly surprised by the continued investment surge, having expected such weak performance to chill investor lust. Even more perplexing is that the investment surge is being fueled by small investors dominated by retirees or those planning for retirement, who had heretofore been wary of volatile stock investments and tended to preferred safer, more stable income generators like bond, income, and money market funds.

Therein lies the method to the ostensibly mad behavior, and it's hardly surprising. The simple fact is that interest rates for "safer, more stable" income funds and savings devices cannot keep pace with the real inflation rate confronting older Americans: soaring expenses like health care and taxes, on the one hand, and shrinking real values of entitlement programs like social security and Medicare, on the other.

With interest income dropping to the range of 5% or lower, these investors have become increasingly desperate for higher rates of return, and have had no choice other than to venture into potentially higher-earning stocks and stock mutual funds. Even though the economy in general, and corporate balance sheets and cash flow in particular, get worse and worse, these small investors have been virtually compelled to keep pouring money into these stocks.

Their situation has become like the impoverished gambler or lottery player against whom the odds are stacked, but who clings to the hope of escaping poverty if he strikes it rich. And these investors have about as much chance as the erstwhile gambler. The reason is the same as the causes for the stock market boom itself over the last two years.

The causes of the boom are twofold. First, as is painfully evident from the decline in output and continuing collapse in employment, the money pouring into the market represents *disinvestment,* a shift of funds out of productive, jobs-producing sectors. Second, and more important, the chimera of "market prosperity" has been the Wall Street elites' prime psychological warfare prop standing between the current "managed decline" and a general financial panic; hence, they have spared no effort ensuring a flow into especially the 30 Dow Jones Industrials—the stocks that are popularly equated with "the market."

While most of the market has indeed been dominated by big institutional pension funds and professional speculators, more and more of the market's new money has come from desperate small investors operating through stock mutuals. Ironically, as more of them jump in, this temporarily "stabilizes" an otherwise untenable market by inflating values, and feeding the bubble that will make the inevitable bust even bigger.

Net stock purchases by mutual funds have grown so much that they now amount to nearly three-quarters of all new stock offerings, thus driving the broad advance in nominal stock "values" over these last 16 months, while spreading the investment over a wide variety and number of companies.

A good number of these investors like to think they're smart by being "conservative." These players have been eschewing the riskier stock funds, choosing instead the most conservative growth and income funds. In April, for example, these kinds of funds raked in 39% more than in December.

This genius, however, is that of idiot savants, because the market is heading for a lollapalooza of a "correction," which they would know if they simply observed the actions of their own stock fund managers. These managers have been holding a rising proportion of incoming funds as cash reserves and highly liquid Treasury paper.

In other words, Wall Street knows the market is overblown. But it keeps taking in sucker money from the little guy, holding a rising proportion of it liquid in order to bail out selected asset values and, they hope, stave off a total paper meltdown.