Weekly Market Commentary

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Buyers & Sellers

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Highlights

At the heart of it, all markets come down to buyers and sellers. U.S. stocks are being purchased by foreigners and corporations, while pensions and insiders remain net sellers. Demand from individuals and hedge funds has been mixed.

Risks to stocks would be a slowdown in corporate buybacks, and a continuation of the slowing pace of net buying by foreigners.

On the other hand, fuel for the stock market could come from a re-allocation back toward stocks by pensions and individual investors.

We devote this commentary each week to assessing the many reasons markets may rise or fall. But at the heart of it, all markets come down to just one thing: buyers and sellers. Taking a look at who is buying and who is selling can tell us something about the durability of the market's performance and what may lie ahead.

Currently, there are six notable trends in buying and selling in the stock market. U.S. stocks are being purchased by corporations and foreigners. Demand from individuals and hedge funds has been mixed. Pensions and insiders remain net sellers.

1 Buyers & Sellers

Investor	Buying U.S. Stocks	Demand Trajectory
Companies	Yes	Accelerating
Foreigners	Yes	Slowing
Individuals	Yes	Flat
Hedge Funds	No	Flat
Institutions	No	Stable
Insiders	No	Accelerating

Source: LPL Financial, various sources cited individually 05/20/13

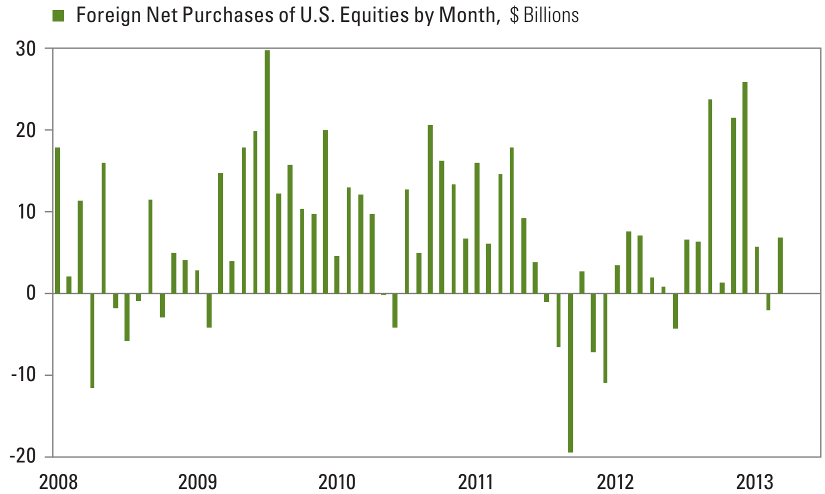
Foreigners

Data released by the Treasury Department last week showed that the pace of net purchases of U.S. stocks by foreigners so far in 2013 has slowed sharply from the strong pace seen in late 2012 [Figure 2], led mainly by a waning of demand from European investors.

Net purchases quadrupled in 2012 over 2011's pace owing to two factors:

1. The net selling that began in July 2011 and continued through year end after the debt ceiling debacle and downgrade in July and August; and
2. The surge in buying of U.S. equities by Europeans that began in September 2012, as the European market momentum stalled after the run-up ahead of the widely anticipated announcement of its bond-buying program by the European Central Bank.

2 Foreigners Demand for U.S. Stocks Waning in 2013



Source: U.S. Treasury 05/20/13

Just as buying rebounded in 2012, we may see stronger demand from foreign buyers as confidence improves that U.S. fiscal challenges will not return the United States to recession as it has in Europe.

The weakest pace of net purchases of U.S. stocks by foreigners at the start to any year since 2004 sets 2013 on a disappointing pace. However, just as buying rebounded in 2012, we may see stronger demand from foreign buyers as confidence improves that U.S. fiscal challenges will not return the United States to recession as it has in Europe.

Hedge Funds

The U.S. Treasury tracks net purchases of U.S. stocks from investors in the Caribbean, which primarily represents demand by hedge funds. The net buying by hedge funds is negligible in 2013, as it was in 2012, with net buying in some months offset by net selling in others. Over the past three years, the monthly average has been a net sale of less than $1 billion of U.S. stocks, ranging from a net purchase of $5.2 billion to a net sale of $10.2 billion.

Companies

Companies themselves have been the biggest buyers of stocks. After reducing purchases during the financial crisis in 2008 and 2009 as companies were focused on hoarding their capital, corporations have returned to near-record levels of net share repurchases. New buyback announcements have surged this year [Figure 3]. Corporations have been aggressively buying back shares, adding up to hundreds of billions in purchases each quarter. Interestingly, the actual number of companies repurchasing shares has fallen as stock prices hit all-time highs, but the total amount spent continues to rise as the buying is concentrated among fewer, larger companies.

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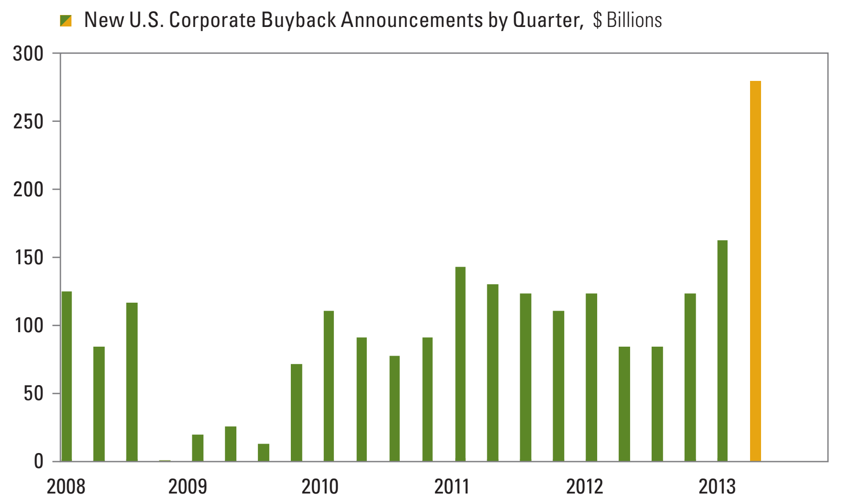
3 Corporations Are Buying Back Shares Aggressively



Source: LPL Financial, Bloomberg data 05/20/13

Corporations have become net buyers of shares as rising cash flow and wide profit margins compel them to shrink their share count to boost earnings per share as revenue growth slows.

Insiders*

In contrast to the buying they are directing their companies to undertake, insiders, or top executives of companies, have been net sellers of shares. While the pace of insider selling often slows during the "blackout" periods around the earnings season, recent data show that the number of shares of S&P 500 companies' insiders have sold relative to those that they have bought has soared. The main reason is that while selling has averaged a below average $2 billion per month this year, buying has been way below average and close to zero.

Should this net selling be seen as an important signal by those "in the know" of impending doom for corporate America? History offers a very different interpretation. Corporate insiders were buying in 2007 at the peak, and they were selling in 2009 as stocks were bottoming. Back in August of 2007, around the peak of the stock market, insiders at financial companies were doing the most buying in 12 years. At the time, this trend was interpreted by some as a buy signal for financials just before the companies in this sector saw their stocks fall more than 80%. Given this track record, we do not interpret the insider selling as a signal that they are acting on any inside information that would benefit an individual investor. Instead, we see it as another indicator of relative demand for stocks.

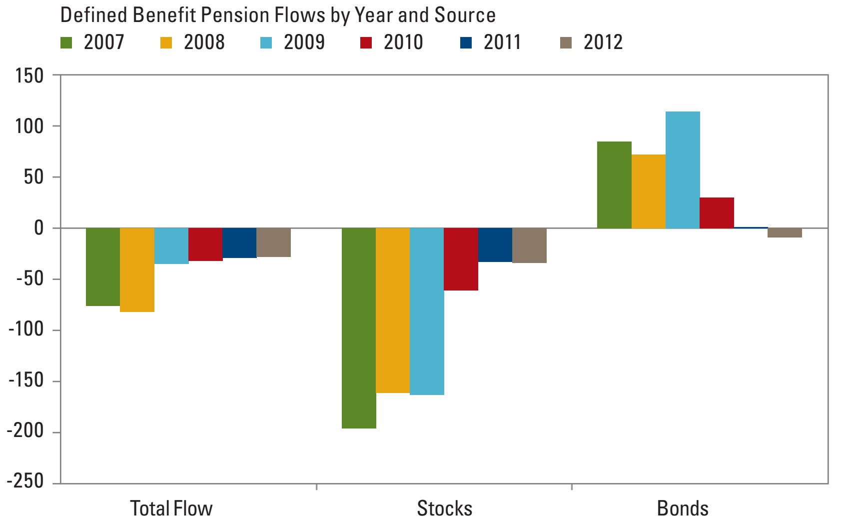
*Data gathered from Bloomberg reported SEC filings.

Institutions

Pension plans, both defined benefit and defined contribution, have been net sellers of stocks. The latest data from the Federal Reserve (Fed) show that

A re-allocation of pension fund assets could be a long-term trend that would affect the investment landscape for many years.

4 Pensions Selling Stocks to Fund Payouts and Greater Allocations to Bonds



Source: LPL Financial, Federal Reserve 05/20/13

through the end of 2012, pensions were selling stocks every year since the Great Recession began in 2008. Data for the first quarter of 2013 will be available in a few weeks, but it is unlikely that pensions have sharply turned around after years of relentless selling quarter after quarter. In the fourth quarter of 2012, although stocks were flat, the value of stocks in corporate retirement plans dropped $40 billion from the previous quarter. Pensions have been selling stocks to fund payouts and greater allocations to bonds [Figure 4]. Stocks now make up only about 53% of pension assets, down from a peak of about 70% before the financial crisis.

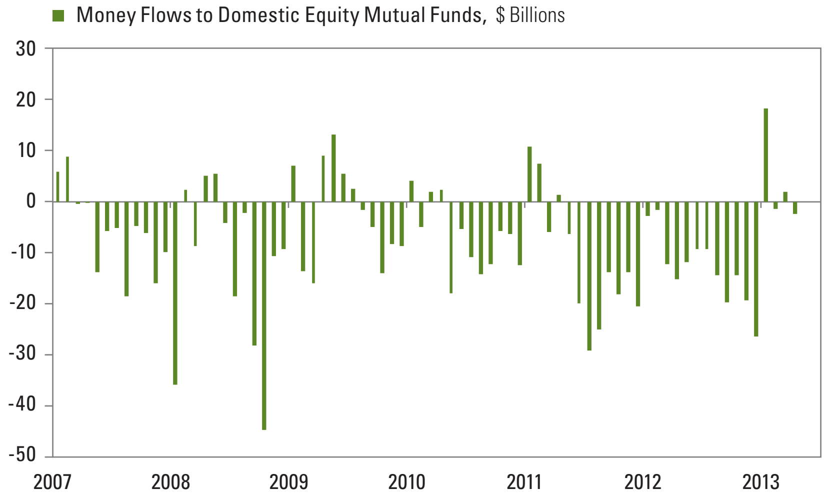
A recent survey by *Pensions and Investments* confirmed that the current asset allocation of major U.S. pension plans now has the lowest percentage of stocks held within investment portfolios over the past 30 years, and 14 percentage points below the average. This may mean that an increased allocation to equities may be coming. A re-allocation of pension fund assets could be a long-term trend that would affect the investment landscape for many years.

Individuals

The power and influence of hedge funds is often discussed and used to explain movements in the markets. However, individual investors as a group wield far more buying power and influence over the marketplace. When individual investors make up their minds, they can be a powerful and durable force in the markets.

Individual investors have been sellers in recent years. It is notable that in 2012, investors in these funds sold more steadily and in a greater amount than they did during the financial crisis in 2008 and 2009. However, individual investors have been net buyers so far this year, measured by the net flows to mutual funds that invest in U.S. stocks. While we have seen

5 Individual Investors Got Off to a Strong Start in 2013



Source: LPL Financial, ICI 05/20/13

buying take place in some of the first six months of recent years, the second half of the year has invariably seen outflows every month. We will have to see if the stronger pace of buying — much of which took place in January after a deal was reached on the fiscal cliff — and the potential renewed interest in stocks in 2013 can be sustained into the second half for the first time in six years [Figure 5].

It is possible that given the experience of the past decade, individual investors may be more cautious in their investing and allocate less to stocks than in the past. However, individual investors may also be saving more. Even if stock investments receive a smaller slice of the pie, the investing pie may be larger due to increased savings. Fortunately, individual investors do not need to wait for the return of better job growth or a rise in their incomes to invest more. In fact, investors have stashed trillions in cash into bank and money market accounts, according to Investment Company Institute (ICI) and Federal Reserve data.

Projecting the Trends

We expect foreigners and companies to continue to be net buyers while insiders remain sellers, and hedge funds will average to flat net buying in the coming quarters. Risks to stocks would be a slowdown in corporate buybacks and a continuation of the slowing pace of net buying by foreigners. On the other hand, fuel for the stock market could come from a re-allocation back toward stocks by pensions and individual investors.

The potential for money to flow into the stock market and lift stocks is significant. However, many investors must first become disillusioned with bonds. Since bonds have historically offered returns over the past 30 years that were competitive with stocks and provided much lower volatility, investors may continue to allocate their portfolios toward bonds as they seek to provide for a secure retirement. It may take a period of rising interest rates from near historic lows to demonstrate the potential for losses and volatility that bond investors throughout the 1970s experienced to reverse the money flows back to stocks.

Evidence of the power of these trends in buying and selling can be seen in the multi-year performance of the bond market (Barclays Aggregate Bond Index) where buying by all parties — pensions, individuals, foreigners, and the Fed — have pushed bond prices higher, and yields to record lows. ■

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of $11.18 trillion and serve nearly 90 million shareholders.

INDEX DESCRIPTIONS

All indices are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

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