Kiplinger's PERSONAL FINANCE

# How to Learn to Love (Stocks) Again

## We show you how to get back into the market without heartbreak.

By **Anne Kates Smith**, From *Kiplinger's Personal Finance,* April 2013

After breaking up with the stock market five years ago, Americans are taking some tentative steps toward reconciliation. Like a lot of troubled relationships, this one has been marked by accusations, recriminations, resentment — and a lot of fighting over assets. What stocks did to investors in the bear market of 2007–09 isn't easily healed — across-the-board losses of 50% and more are hard to forget and even harder to forgive. But at the start of 2013, it looked as though investors were ready to renew their vows.

Lou Horvath, a retail manager in Pembroke, Mass., is among those willing to give stocks another go. Horvath, 44, invested aggressively in stocks until the financial crisis cut his port-folio in half. "I pulled out and stayed out for three years," he says. But last fall, Horvath met Jeff Cutter, an adviser in Falmouth, Mass., who made him feel better about getting back into the market by recommending funds that aim to reduce volatility and risk by adjusting their exposure to stocks as their managers see fit. "I'd like to see how this goes, then reevaluate," says Horvath, who still has half of his assets in bonds and certificates of deposit.

Investors who can figure out how to forge a lasting relationship with stocks are likely to be rewarded in the long run. What's surprising is that people only now seem to be coming around to the notion. After all, from the bear market's bottom in March 2009 through February 1, Standard & Poor's 500-stock index returned a sturdy 143% (or 26% annualized). And yet for most of the upswing many individual investors ignored the bull market. Others mistrusted it. And some didn't even realize it existed. Despite a 16% gain logged last year alone, nearly half of Americans surveyed in December by the Edward Jones brokerage firm thought that the market was down or flat in 2012.

### Confidence returns

Now, though, propelled by small progress on the nation's fiscal challenges and mostly encouraging economic signs here and abroad, the market has surged 12% from mid November through February 1. That pushed the S&P 500 to just 3% below its record high of 1565, set in October 2007, and caught people's attention.

Since the start of the year, investors have been pouring money into stock mutual funds. In January, stock funds took in $41 billion more than they lost, according to Strategic Insight, a fund-research firm. The figure represents the first positive monthly net inflows since April 2011.

Optimism is high. According to a recent survey by the American Association of Individual Investors, 48% of those polled said they were bullish on the stock market. That's well above the long-term average of 39%. It remains to be seen, however, whether the wave of investors returning to stocks will become a groundswell. The start of the year is seasonally strong for mutual funds as investors seed retirement accounts, and $41 billion doesn't go nearly far enough to erase the $548 billion that came out of stock funds between 2008 and 2012. Moreover, the next economic calamity, here or abroad, could send investors running for the exits again.

Plenty of people, the recent rally notwithstanding, are still scared stockless. Matthew Hammer is emblematic of a generation smacked so badly at the start of their investing careers that they want nothing to do with stocks. For Hammer, 30, a post-doctoral computer science researcher at the University of Maryland in College Park, it's not just the stock market crash but also the attendant financial scandals that have colored his outlook. Says Hammer: "My cynicism goes deep. I think the financial industry is one big pyramid scheme — or a series of related pyramid schemes. It's like a carnival where all the games are rigged. You're just going to get swindled if you try to participate." Hammer's money now goes into a checking account at his bank.

Older hands have lost faith, too. Ed Harrop, 64, recently retired from Johnson & Johnson, is nostalgic for the days when investors had time to ponder portfolio decisions. "What drives investment decisions now is overwhelming to me, with the vast amounts of data you need to process and the speed with which computer trading and news announcements seem to move the market." Harrop, who has half of his investment assets in J&J stock, had intended to invest more actively upon retirement. "Now, it doesn't seem like fun," he says. "I'd be standing there with a whole bunch of VHS tapes in a CD world." Make that a digital world, where computer algorithms can storm the market in nanoseconds.

## Rekindling an old flame

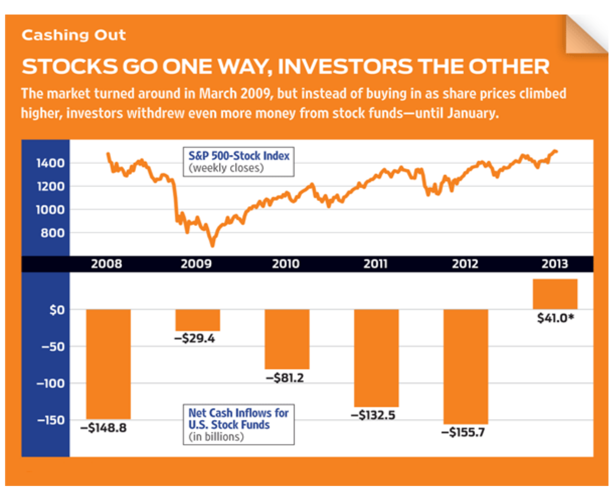
Holdouts like Harrop and Hammer will be hard to lure back into a market that can be mercurial, mysterious and sometimes flat-out badly behaved. Even so, there are good reasons for almost every investor to learn to love — or at least live with — stocks again.

One of the chief arguments for owning stocks is that your portfolio simply cannot be diversified without them. "By definition," says Ben Birken, a financial planner with Woodward Financial Advisors, in Chapel Hill, N.C., "a portfolio without stocks isn't well diversified. That would be like having only 500 out of 1,000 pieces and claiming that you still had a puzzle."

That's not to say that a diversified portfolio, which holds an array of assets, doesn't take its knocks in the market. When nearly all stock market sectors and most asset classes (except Treasury bonds) collapsed in 2008, many market watchers questioned whether diversification was still a relevant strategy. But over time, a diversified portfolio provides the best combination of reasonable returns with bearable volatility. Researchers at fund company T. Rowe Price compared the returns of portfolios that varied from 100% in bonds to 100% in stocks with various combinations of stocks, bonds and cash in between those extremes. From 1985 through 2012, a portfolio of 60% stocks, 30% bonds and 10% cash would have returned 9.8% annualized — about 93% of the return of an all-stock portfolio, but with just 62% of the risk.

Many investors' portfolios today are lopsided in favor of bonds. The flight to safety was a good call during the bear market in stocks; but today, the risks in bonds are greater, and the values in stocks are better. For now, bondholders can expect to earn whatever they collect in interest, with little or no price appreciation — which means returns in the low single digits. That compares with a likelihood of high single digits — and possibly more — from stocks. For income investors, dividend-paying stocks are an enticing alternative to bonds, with the 2.2% average yield on S&P 500 stocks eclipsing the 2.0% yield on ten-year Treasuries, and with many high-quality companies offering dividend yields well above the yields of their bonds.

Because interest rates have been on the down escalator for more than three decades, investors may be unprepared for the risk of higher rates (bond prices move in the opposite direction of interest rates). Bond market yields won't rise right away; the Federal Reserve has committed to keeping short-term interest rates, which it controls, low until the unemployment rate falls further, and it is trying to keep market rates down through its massive bond-buying program. But bond investors almost certainly will anticipate rate hikes before the Fed starts tightening. A rise in yield of less than a half-percentage point would reduce the return of a ten-year Treasury to zero over the course of a year.




*Estimated through January 31. SOURCES: Investment Company Institute, Strategic Insight

**The cost of inflation**

Investors should also remind themselves that although inflation hasn't been much of a worry in recent years, even a modest amount will nibble away at the value of a portfolio over time. Stocks don't always beat inflation over short periods, especially when it's caused by sudden spikes in oil or other commodity prices. But over the long haul, stocks are a powerful defense. Even if consumer prices rise at a moderate 2.5% annual rate (the long-term historical average is 3%), the damage over time is significant, reducing the buying power of $1,000 to $610 over 20 years. Based on data going back to 1926, Morningstar's Ibbotson unit reports that long-term bonds have historically returned just 2.6% annualized after inflation, while large-company stocks have delivered close to 7%.

Fickle investors who move in and out of stocks learn that serial breakups are expensive. Poor timing — selling low and buying high — explains why the average investor's return trailed the S&P 500 by an average of more than four percentage points per year from 1992 through 2011, according to Dalbar, a research firm that tracks investor behavior.

That lesson hit close to home for Atlanta lawyer John Snyder, who has careened from risky stocks to conservative bonds a couple of times since 2008, while his wife, Sharon Collins, has favored a steadier strategy. John was fully invested in stocks in 2008, lost big, and then cashed out just as the market bottomed. Frustrated with the lower returns he subsequently earned in a more conservative asset mix, Snyder started playing the stock market again. When the fiscal cliff and economic troubles in Greece roiled the market in 2012, he fled again. "I was like a day trader at my law job," says Snyder. "I realized I'm not very good at it, plus it's stressful as hell."

Atlanta-area financial planner Carol Berger, at Halcyon Wealth Management, has worked Snyder up to a portfolio split evenly between stocks and bonds. But all the while, Collins has maintained a mix of 60% stocks and 40% bonds that Berger periodically rebalances. Collins's portfolio is up 13% over the past 12 months and up a cumulative 26% since the start of 2010, while John has eked out 4% and 3%, respectively.

Perhaps the best reason of all to buy stocks now is that the four-year-old bull market appears to have plenty of life left. Strength in the stock market is widespread and getting broader. The number of stocks rising in price compared with those falling reached a new high in January, signaling broad participation in the rally. Corporate earnings growth, the stock market's ultimate engine, is back in gear after stalling in the third quarter of 2012.

And yet, stocks still represent good value, selling at an average of just 13 times next year's estimated earnings, below the ten-year average of just over 14. If fears of a new recession, another meltdown in Europe and a fiscal catastrophe here finally recede, investors may be willing to pay more for each dollar of corporate earnings, pushing up price-earnings ratios (and stock prices). Market strategist Ed Yardeni thinks the S&P 500 could close at 1665 by year-end, a 10% gain from its February 1 close. That doesn't mean stocks won't pause or even stumble along the way.

**Getting back in**

*How* you return to the market matters, especially after a hiatus. Even if you're anxious to get back in the game, you'll want to buy into stocks gradually. Investing a set amount periodically, a strategy called dollar-cost averaging, helps you psych yourself into sticking to your investment plan. Putting every-thing in the market at once guarantees that you'll know all too well what you've lost if you happen to invest at the wrong time. Investing at intervals erases that fixed reference point, which helps keep the aversion to losing money that we all have from becoming paralyzing. Dollar-cost averaging also lowers the average per-share cost of your stock holdings by ensuring that you buy more shares when prices are down and fewer shares when they're richly priced.

Deciding how much stock is enough depends on your age, circumstances and tolerance for risk. And stocks are best used to reach longer-term goals, such as college savings and retirement, and not for immediate needs, such as an emergency fund or a down payment on a house you're buying soon. For example, according to Morningstar, a young, aggressive investor who won't retire until 2045 should earmark 93% of assets for stocks. An investor with a moderate tolerance for risk who is retiring in 2030 might put 76% of assets in stocks. But even conservative investors who are already retired need some stocks. Someone who retired in 2010 and has a low tolerance for risk should keep 25% of assets in stocks, says Morningstar.

You might want to let someone else figure out how much of which assets to own, as Ted Johnson did. Johnson, a 57-year-old postal worker in Minneapolis, stashed savings in a government bond fund in his retirement plan at work for most of his career because he got clobbered every time he found the courage to move into stocks — during the tech bubble of 1999 and 2000, and again in the financial crisis of 2008. Yet he knew the "minuscule" fixed-income yields he was earning would not keep up with inflation. In January, Johnson solved the dilemma by moving everything into a target-date fund, which offers diversification among stocks, bonds and perhaps other asset classes, and automatically becomes more conservative as his retirement year approaches. "These back-and-forth markets — it was too stressful," says Johnson.

Investors who leave the asset-class decision to others tend to stay invested longer. Over the 20-year period through 2011, investors in hybrid mutual funds stayed in the funds for an average of more than four years, compared with just over three years for stock fund investors and three years for bond fund investors, according to Dalbar. Hybrid funds include both target-date funds and balanced funds, which toggle between stocks, bonds and money markets, within set parameters. Industry giants Fidelity, T. Rowe Price and Vanguard offer target-date funds. We have a slight preference for the Price and Vanguard funds. Price's funds have the most aggressive mix, and Vanguard's the most conservative.

A good one-stop balanced fund worth considering is **Vanguard Star** (VGSTX), a diversified mix of other Vanguard funds that invest in bonds as well as U.S. and foreign stocks. **FPA Crescent** (FPACX), a member of the Kiplinger 25, owns everything from stocks and bonds to preferred shares, convertible securities and bank loans, a mix that does well in up and down years.

For super-skittish investors, financial planner George Kiraly Jr., at LodeStar Advisory Group, in Short Hills, N.J., favors **Vanguard Wellesley Income Fund** (VWINX). The fund, which holds about one-third of its assets in stocks and the rest in high-quality bonds, lost only 10% in 2008 and has returned nearly 8% annualized over the past decade through February 1.

If wild swings in the market wreak havoc with your financial fortitude, focus on low-volatility investing. By sidestepping big market swings, you won't just sleep better, you may even beat the market in the long run. That's because large losses cost investors more than big gains can make up. Research coauthored by Brendan Bradley, director of managed volatility strategies at Boston-based Acadian Asset Management, shows that from 1968 through 2012, a portfolio of low-volatility stocks would have returned 11.2% annualized, compared with 9.5% for the S&P 500. You'll find scads of low-volatility stocks among the household names on your shelves (think General Mills, Clorox and Johnson & Johnson). Make sure the stock's beta, which you can find on investing sites such as Yahoo Finance, is below the market's beta of 1. The easiest way to go low-vol is with one of a new crop of exchange-traded funds, such as **PowerShares S&P 500 Low Volatility Portfolio** (**SPLV**).

Once you're back in the market, try to think like a business owner, not a stock trader. If you ran a deli on Main Street, you'd keep the doors open in good times and bad until you met your goals — barring a fundamental deterioration of the business itself. It works the same way on Wall Street.