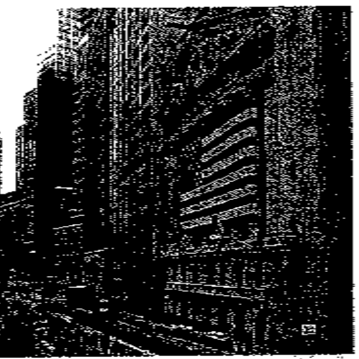
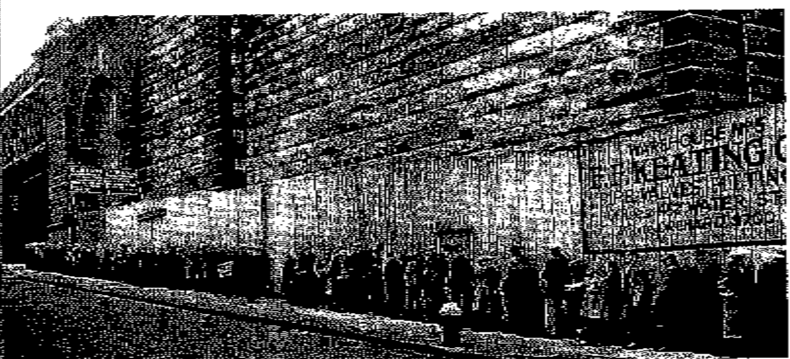
Financial markets face a lost generation of investors





Collateral damage from economic crisis has long-term impact

By Dan Jamieson

Just as the Great Depression scared an entire generation away from the stock market, recent events may drive today's investors to the sidelines — forever.

The economic downturn, plummeting real estate values, seemingly daily revelations of fraud on Wall Street and a financial system that is teetering precariously on the brink of insolvency have turned the world upside down for individual investors. It remains to be seen whether those investors will ever regain their confidence in investing, said financial advisers, stock market historians and experts on behavioral finance.

"If we get another two or three

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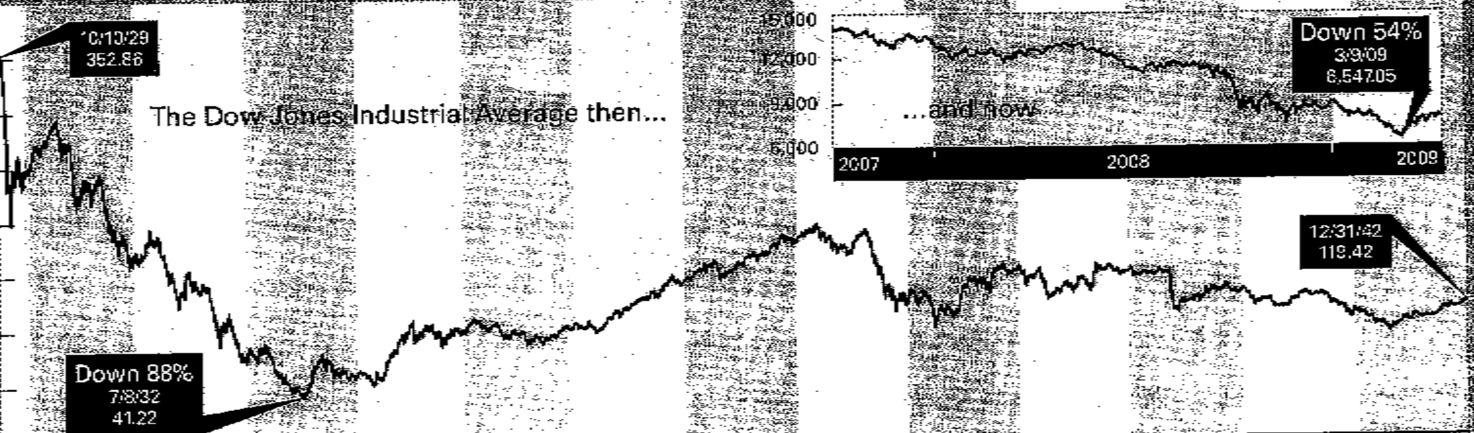

'Lost generation' of investors

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years of bad returns, we stand a chance of losing a generation of investors," said Jason Zweig, editor of the updated edition of Benjamin Graham's "The Intelligent Investor" (HarperCollins Publishers Inc., 1973).

For some financial advisers, that generation is already lost.

"The [clients] who are gone are gone," said Ed Finder, founder of Star Finder Financial Management, a division of Axiom Investment Management LLC in New York, who runs $120 million for clients.

"They're out, and they want to stay out," he said. "There's no confidence left."

Who can blame investors for questioning the soundness of investing in stocks?

MARKET TRAUMA

During the past 18 months, stock prices have fallen to levels not seen in more than a decade; the retirement savings of millions of Americans have been decimated, and shellshocked investors have yanked billions of dollars out of stock mutual funds in a desperate effort to preserve what was left of their savings.

The Dow Jones Industrial Average fell more than 54% from an all-time high of 14,164.53 Oct. 9, 2007, to 6,547.05 March 9 of this year, its most recent record low.

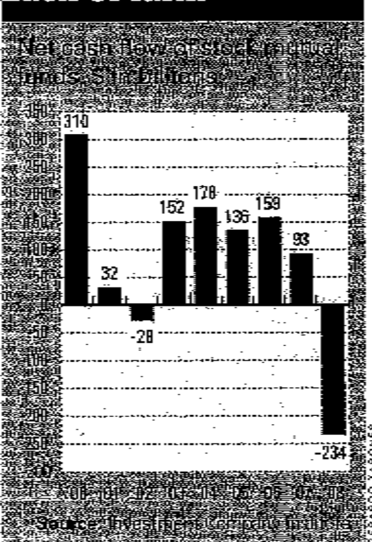
What's more, the Standard & Poor's 500 stock index plunged a staggering 57% to 676.53, from 1,565.15 during the same period. That is the largest peak-to-trough drop since the 1929-32 collapse, when stocks in the index fell 86%.

If that isn't bad enough, during the 10-year period ended March 31, the index fell 38%, marking the first decade of losses in more than 30 years.

It is no wonder that money and the state of the economy were two of the top sources of stress for 80% of tion's 2008 Stress in America Survey, which was released in October.

"The most comparable thing now is the crash of 1929 and the Great Depression," said Mr. Zweig, who also writes about the psychology of investing for The Wall Street Journal. "Unfortunately, the message is not terribly encouraging."

William Bernstein, a market historian and founder of Efficient Frontier Advisors LLC in Eastford, Conn.,



which manages $116 million, agrees.

"You lost an entire generation of investors after 1929 who just didn't invest," he said. "It could happen again."

Part of the problem is that investors have ricocheted from one cataclysmic market event to another. First, for example, was the drop in home values, followed by the stock market's nose dive, followed by revelations that Bernard Madoff absconded with billions of dollars in investors' savings.

Although any one of those events would have been enough to unnerve investors downright freaked out.

"The strongest kind of fear is fear of the unknown, and that's been characteristic of this crisis from the beginning," said Andrew Lo, a professor at the MIT Sloan School of Management in Cambridge, Mass., and a researcher in behavioral finance. "The traumatic events of 2008 will lead to potential damaging behavior on the part of investors unless they are aware of the hyperstimulated emotional state they're in."

Even if today's investors haven't been scared away from the stock market for good, it will likely be years before they regain enough confidence to dip their toes back in, experts said.

"The problem is what I call mega-meltdowns, 40%-plus drops," said Sam Stovall, chief investment strategist for Standard & Poor's in New York. "We've had five since 1929, and the median [time] to get back to even is 69 months, so six years, basically."

Those mega-meltdown periods were 1937-38, 1938-42, 1973-74, 2000-02 and the current period.

Six years may be optimistic. After the 1932 low, it took the stock market 25 years to recover to its prior peak, Mr. Stovall said.

Cyclical bear markets within secular downturns can be deep and long, said Will Hepburn, founder of Hepburn Capital Management LLC of Prescott, Ariz., which has $20 million under management.

The 1930s through the early 1940s saw five cyclical downturns, said Mr. Hepburn, who is also president of the National Association of Active Investment Managers Inc. in Littleton, Colo. The period from the late 1960s through the 1970s experienced four cyclical bear markets.

This time around, "history shows we'll have more" market drops before the bottom is reached, Mr. profound for those in or near retirement. "[Baby] boomers are the ones feeling the pain," said Diahann Lassus, president of Lassus Wherley & Associates PC of New Providence, N.J., which manages $250 million.

Older investors with accumulated savings have lost the most and are "most likely to jump off the ledge," said Ms. Lassus, who is also chairwoman of the National Association of Personal Financial Advisors in Arlington Heights, Ill.

That said, even younger investors are scared — especially since so many have been shaken by losses in their 401(k) plans, raising questions about the wisdom of self-directed plans.

"We've shifted far too much responsibility onto [retirement plan participants]," said Alicia Munnell, a professor at Boston College and director of the school's Center for Retirement Research.

In 2004, she co-wrote a book, "Coming Up Short: The Challenge of 401(k) Plans" (Brookings Institution Press), which concluded that many people are incapable of making wise decisions about their 401(k)s.

"The financial crisis makes [those shortcomings] even more clear," Ms. Munnell said.

Many advisers are just as dazed and confused as their clients.

Although some see opportunities in the market, few escaped major losses. Many are rethinking their investment philosophy.

"I'm definitely reconsidering to some degree ... how to implement my allocation strategies," said Charles Farrell, an investment adviser with Northstar Investment Advisors LLC in Denver, which manages about $300 million. Advisers in general held too many assets that "all correlated the wrong way, [and they] didn't have enough straightforward [Treasury] debt and well-diversified corporate[-bond the more actively managed funds" that use a tactical approach, Ms. Lassus said. "I've never been a fan of active managers, but we've decided that [adding some tactical] approaches can keep you from getting killed."

During 2008, when investors most needed the benefits diversification, it didn't work, according to observers. And the market collapse has raised questions about whether many advisers relied too heavily on stocks to help their clients reach their financial goals.

Robert Arnott, chairman of Research Affiliates LLC, a Pasadena, Calif.-based index provider, has long argued that the expected excess returns from stocks have been exaggerated. In an upcoming article to be published in the Journal of Indexes, he points out that from February 1969 through February 2009, investors in 20-year Treasury bonds actually fared a bit better than investors in the S&P 500.

Many advisers and consultants assume that stocks will beat bonds by 5 percentage points per year, Mr. Arnott said.

But the long-term risk premium of equities over bonds, based on the 207 years of history he studied, is just 2½ percentage points, he said.

"Stocks in the long run will beat bonds more often than not, but the fallacy is that it doesn't matter what you pay [for stocks as long as] you're patient," Mr. Arnott said. "That's just rubbish; what you pay matters hugely."

That is an expensive lesson advisers, and their clients, are just learning.

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On May 4, Part Two in the Lost Generation series looks at how the financial crisis will reshape the entire