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Don't Be a Hater: Stocks are NOT Evil

By Dave Friedman

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There comes a time in every market downturn in which the individual investor, the fabled "man on the street," comes to hate stocks. Stocks are what most people are most familiar with in the financial markets. Therefore it's easy for people to hate them, even though stocks are generally very liquid, and relatively safe investments. If you need to raise $100,000 by yesterday to pay off your loanshark, you'll have better luck doing that by liquidating your portfolio than by listing your house for sale.

My colleague Damien Hoffman recently blogged about the psychology of a market cycle. It makes for some interesting reading. It is curious, then, to read articles which claim that people have come to hate stocks. Consider a recent article from USA Today. Rife with anecdote, it claims:

> [I]nvestors on Main Street are not playing the stock market game with confidence like they used to, mainly because the game of making money has gotten tougher and more volatile since the financial crisis. Retail investors are buying fewer stocks. They are paring back on stocks and stock funds they already own. Instead, they're moving into safer investments, like cash and bonds.

There are a couple of problems with this argument. First, the last thing that "Main Street" investors want to do is to consider the stock market a "game" for "game" implies that there are those who have the skills to win and those who don't. Guess who has the skills to win at the game that is the financial market? It isn't individual investors. Second, the value of cash declines over time due to inflation, and bonds are subject to very small interest payments, unless they are risky junk. Securities such as bonds and assets such as cash are not necessarily

safer than stocks. They are merely different.

The article continues with this illogic:

> "I'm sitting on an uncomfortable amount of cash," says Harris, editor of Stacy's Music Row Report, an online publication that blogs about the country music scene. "Until things get better, I'm not putting any more money into stocks."

The problem is that we won't know that things "get better" until, well, they are better. By which time Harris, and many others like him, will have missed out on the market's general run-up. Now, no one knows if things will "get better" tomorrow, next month, next year, or next decade. But the conceit that a publisher of a country music newsletter can time the market any more accurately than the thousands of bankers, pundits, and prognosticators out there beggars belief.

That said, there are legitimate reasons for uninformed investors to feel queasy about the stock market:

> It's hard to blame individual investors for their growing skittishness toward stocks. They've endured not one but two of the worst stock market downturns in history — within a short 10-year span. The dot-com-inspired stock bubble burst in early 2000, knocking the broad stock market, as measured by the Standard & Poor's 500-stock index, down 49.1% by the time the bear market ended in 2002. That was followed by the 56.8% plunge from 2007-09, when a credit-driven bubble in stocks, real estate and many other assets ended badly.
>
> As a result of the back-to-back bear markets, the Dow Jones industrial average is still trading just 270 points above the 10,000 level, a milestone it first attained to great fanfare back in 1999. Since the Oct. 9, 2007, high, the stock market's value has declined by $5.6 trillion, according to Wilshire Associates. "Investors are saying, 'Why would I want to put money into stocks? I'm still losing money,' " says Charles Biderman, director of research at TrimTabs, a firm that tracks fund cash flows.
>
> Panzner ticks off three other key reasons Main Street investors have suddenly turned very risk-averse:
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> •Investors are trying to make sense of an unprecedented economic earthquake that has left them feeling blindsided and unsure about their economic futures like never before. Nearly 15 million are unemployed, and many have seen the value of their homes — typically their biggest investment — crater.
>
> •There is a feeling among investors, Panzner says, that the investment "game is rigged" in favor of professional traders and money managers. The belief that the playing field is not level has created intense feelings of animosity toward Wall Street.
>
> •The aging of the Baby Boomers has created a demographic headwind for the stock market.
>
> "More people will be looking to draw down their savings," Panzner says. "As people get older, they will want to take less risk and protect their nest eggs."

While it's true that ordinary investors have less information available to them than professional investors, and

some professional investors cheat at the expense of individual investors (and other professional investors), it is nonetheless also true that perception becomes reality. If individual investors think they are getting a raw deal, then they are convinced that they are getting a raw deal and they decline to participate in the equity markets.

There is no easy solution to this. Financial illiteracy is widespread, even among market participants, and even among professional market participants. Financial markets are extremely complex things, and very few people are willing or able to understand them in sufficient detail to be able to claim an ability to manage risk and volatility better than most other people. Regulators have proven inept and managing the risks of various financial markets.

This leads us to wonder what will make "Main Street" investors come back to the stock market. The article offers some good ideas:

> •A new bull market. Animal spirits will return when the stock market starts heading higher and your neighbor starts bragging about all the money she made in the market, says Michael Farr of money management firm Farr Miller & Washington. More days like Wednesday, when stocks soared 3%, are needed.
>
> "We need a bull market somewhere in something," Farr says. "As soon as the guy next door is making a buck, investors' curiosity will be piqued," and they will regain their courage and start investing in stocks again.
>
> To drive home his point, he uses a casino analogy: "The reason slot machines have ringing bells and flashing lights" to announce a winner is that it "keeps everyone else pulling their handles. You don't have to be the one that wins, you just have to know someone is winning."
>
> •Clarity over government policy. All the question marks on government policy, ranging from taxes to financial regulation, are stifling business decision-making and innovation, Merk argues.
>
> "A key ingredient to functioning markets is clarity," Merk says. "You need to know what the government is up to. But we just don't have that. Investors will come back to the business of investing when investment can take place based on analysis of businesses, rather than anticipating the next government intervention."
>
> •A resurgence of dividends. In a world where yield or income is gaining popularity at the same time that yields on government bonds are sinking to or near record lows, investors will be more apt to return to stocks if companies upped their dividend payouts, argues Jason Trennert of Strategas Research Partners.

I see two main problems with individual investors' aversion to the stock market: (1) there aren't many good alternatives out there, and (2) financial illiteracy is widespread and people resort to illogical notions of being able to time the markets in the way that professional traders can (infrequently) time it. Neither of these positions holds up to scrutiny. Unfortunately when it comes to matters of finance, few people are willing to approach it logically.

David Friedman is the Editor of our new Wall St. Watchdog platform. Click here to follow Wall St. Watchdog on Twitter.

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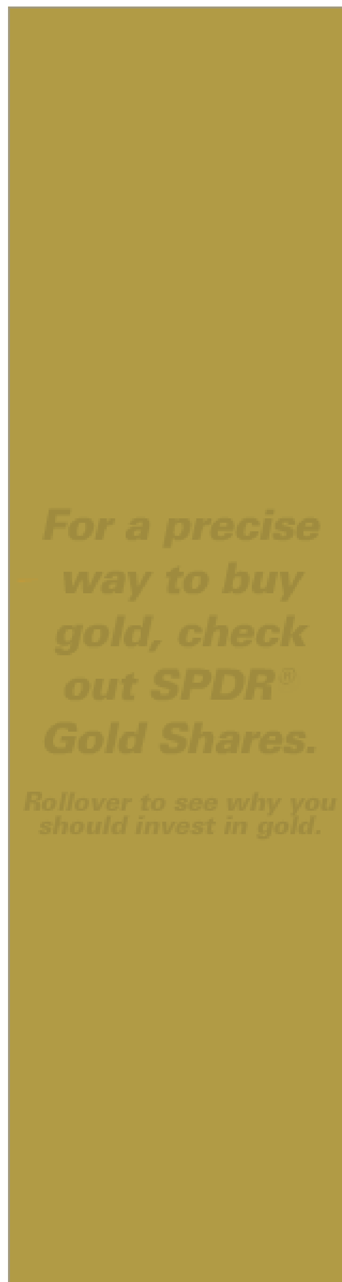

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