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Volatile Stocks to Leave Lasting Investor Scars

By Laura Keeley - Aug 18, 2011

Last week's record volatility in U.S. stocks ended after four days. The anxiety it instilled among mutual-fund investors may linger for years.

Investors pulled a net $23.5 billion from U.S. equity funds in the week ended Aug. 10, the most since October 2008, when markets were reeling from the collapse a month earlier of Lehman Brothers Holdings Inc., the Investment Company Institute said yesterday. The period tracked by the Washington-based trade group included three of the unprecedented four consecutive days in which the Standard & Poor's 500 Index rose or fell by at least 4 percent.

The roller-coaster ride was unnerving for fund investors who have already endured the bursting of the Internet bubble in 2000, a 57 percent collapse in the S&P 500 Index (SPX) from October 2007 to March 2009 and the one-day plunge in May 2010 that briefly erased $862 billion in value from U.S. shares. The debacles, combined with falling home prices, unemployment above 9 percent and a lack of trust in government to bring down spending, may sour individual investors on domestic stock funds for an additional three to five years, according to Andrew Goldberg, a market strategist at JPMorgan Funds in New York.

"You can't keep having bombs, so to speak, go off," Goldberg said in a telephone interview. "If the second you walk outside another one goes off, you're going to stay inside for longer, and that's what's going on."

The S&P 500 tumbled 4.5 percent today on growing signs the economy is slowing and speculation that European banks lack sufficient capital.

History Not Repeating

The $12.2 trillion mutual-fund industry has historically been able to count on investors to come back to stocks after a significant selloff. They did so following "Black Monday" in October 1987, the Asian currency crisis in 1997 and Russia's debt default

in 1998. In the year after the 2000-2002 bear market, U.S. equity funds attracted $130 billion, ICI data show.

Funds that buy domestic stocks lost $98 billion in 33 straight weeks of withdrawals last year after the 20-minute plunge in May, ICI data show. They've had redemptions of $74 billion this year. The latest withdrawal streak began in 2007 and didn't end even as stock surged from their March 2009 lows.

"What we have seen this time is a much slower return to risk-taking," said Francis Kinniry, principal at Vanguard Group Inc. in Valley Forge, Pennsylvania, the largest U.S. mutual-fund manager. He attributes the difference to falling home prices. In bear markets prior to 2008, residential property values were rising.

"There was significantly more wealth destruction this time around," Kinniry said.

Index Funds, Bonds

Investors have compensated by shifting some of their money into passively managed index funds and exchange-traded funds that track stock benchmarks, forsaking managers who select the investments they buy and sell.

U.S. stock index funds have posted net deposits every year since 2001, according to Morningstar Inc., a Chicago-based research firm. Investors have similarly poured $851.5 billion into ETFs for all asset classes from 2001 to July 2011. Unlike mutual funds, ETF trade throughout the day like stocks.

Bond funds also have been winners, adding $75 billion in deposits this year, while funds that buy non-U.S. stocks took in $15 billion, according to ICI.

"Over the past couple of years and especially the past couple of weeks, I have heard a large number of clients and acquaintances express fear and dislike for the stock market," Eitan Tashman, a financial planner in Beverly Hills, California, said in a phone interview. While "many investors are scared of the volatility and seeming instability of the stock market and would even like remove their money from the stock market," there are few alternatives, he said.

Baby Boomers

The post-World War II generation known as the baby boomers is the largest group of investors in mutual funds, said Geoff Bobroff, an investment-management consultant in East Greenwich, Rhode Island. As they go into retirement, they might not return to equities after two bear markets and the volatility this year, he said.

“They are already thinking now about their retirement years,” Bobroff said. “They may be in fixed-income of different flavors, but equities may no longer be on their horizon.”

The recent volatility makes Mark Beller, 42, a physician in Northridge, California, want to put more of his money into real estate.

“The market is so volatile, 1,400 points in a week? Give me a break,” Beller said in a phone interview. “I have money to invest, and my portfolio is down about 15 to 20 percent, so I’m going to wait for it to come back to where I feel comfortable.”

Cash is King

Younger investors aren’t replacing their retiring counterparts. Cash holdings are at the highest levels since the record in March 2009, according to an Aug. 16 survey by Bank of America Merrill Lynch. Investors from 18 to 30 years old have the highest cash position of any age group at 30 percent of their portfolio, MFS Investment Management said in an Aug. 8 report. Almost three in five investors cite fear about volatility or needing money someday as a reason they hold high or increasing levels of cash.

“Investors are in cash for a reason and, regardless of time horizon, conventional investing wisdom no longer applies,” William Finnegan, senior managing director of retail marketing at the Boston-based firm, said in the report. “The Great Recession of 2008 has had a profound and longer-lasting impact on investors’ confidence than expected.”

The average investor tends to hold large amounts of cash when the markets are at a low and thus miss out on gains, JPMorgan’s Goldberg said. The previous high of cash as a percentage of portfolios was in October 2002, right before the start of a five-year bull market.

Institutions Hold Tight

"Households had become so conservative that they were sitting on all this cash that should've been seeking out opportunity," he said. "To the extent that emotions drive decisions, they're going to get it wrong."

Brad Durham, managing director of research at EPFR Global in Cambridge, Massachusetts, said retail investors are exiting funds while institutions are modestly adding to their holdings. Retail investors pulled $26 billion from U.S. equity funds from May 1 to Aug. 10, while institutions added $689 million, he said.

"Institutions are using this period to change their exposures around and they're not selling as aggressively, while retail investors have just been fleeing," Durham said.

The return of the S&P 500 during the past 10 years has been about 3 percent including dividends. Investors have experienced "a far greater degree of volatility than one would expect for such meager returns," Greggory Warren, a Morningstar analyst, wrote in a June 29 research note.

Toll on Managers

"The problem is you don't really know what to do," said James Dean, 67, a salesman for an information-services company who lives in Panama City, Florida. "There's no rhyme or reason for the market to be doing what it's doing other then the mess our government has gotten us into."

The investor exodus is taking a toll on publicly traded fund companies. The S&P index of money managers and custody banks has fallen 15 percent since the May 2010 plunge, compared with the 5.8 percent increase by the S&P 500, a benchmark for the largest U.S. companies.

Janus Capital Group Inc. (JNS), which is off 47 percent, led the drop. About 89 percent of the Denver-based company's assets under management is in stock funds. It has had eight straight quarters of net withdrawals totaling $21.6 billion.

American Funds, Fidelity

Closely held American Funds and Fidelity Investments are among the big asset managers bearing the brunt of investor defections from U.S. stock funds, according to Morningstar. American, owned by Los Angeles-based Capital Group Cos., had an

estimated $43 billion in redemptions this year through July, while Boston-based Fidelity lost $8.8 billion, Morningstar data show.

Diversified managers such as Invesco Ltd. (IVZ), BlackRock Inc. (BLK) and Franklin Resources Inc. (BEN) are the firms best prepared to capitalize on the environment, Morningstar's Warren said. Invesco, based in Atlanta, bought Morgan Stanley's Van Kampen mutual funds last year, giving it a broader domestic base. San Mateo, California-based Franklin has 89 percent of its assets outside of domestic equities. The Templeton Global Bond Fund attracted $10.9 billion through June, the most of any U.S. mutual fund.

BlackRock of New York, the world's largest asset manager with $3.66 trillion assets under management, owns iShares, the biggest provider of ETFs.

'Pleasantly Surprised'

Vanguard, which has about half its mutual-fund assets in index funds, saw net deposits of $30 billion this year through July, according to Morningstar. At Pacific Investment Management Co., the Newport Beach, California-based manager of the world's biggest bond fund, investors put in $25 billion this year.

Not all investors are panicking or leaving the market.

"Generally, they're holding tight, and I've been pleasantly surprised," Kevin O'Reilly, a financial adviser based in Phoenix, said in a telephone interview. "I haven't gotten, really, nearly as many calls panicking as I thought I would have."

Investors may be getting used to the volatility, which isn't necessarily a good thing, said Lee Ann Knight, a financial adviser in Bedford, Massachusetts.

"They may be immune to worrying about it when they should be," she said. "What surprised me is that I have had a few phone calls from people wanting to use this opportunity to invest. That's great, that's good, but I feel like I had these conversations for 10 years, and people were like, 'No way, no way." '

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