

## Is it back to the Fifties?

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My mother is 75," said Jon Stewart, the US late-night comedian, at the end of his already famous interview with Jim Cramer, the television stock market pundit. "And she bought into the idea that long-term investing is the way to go. And guess what?"

"It didn't work," replied Mr Cramer.

The interview this month, in which Mr Stewart humiliated his guest, has earned a place in American cultural history. Mr Stewart was articulating a broad sense of betrayal among the populace that the faith all had been told to put in equities had been misplaced.

That loss of faith spreads beyond retail investors. The crash has forced professional investors and academics to question the theoretical underpinnings of modern finance. The most basic assumptions of the investment industry, and the products they offer to the public, must be reconsidered from scratch. Indeed, the very reason for the industry to exist - a belief that experts make the smartest decisions on where people's money will do best - is up for scrutiny as a result.

Mr Stewart was right about long-term investment, and not just for septuagenarians. US stocks have fallen more than 60 per cent in real terms since the market peaked in 2000. Anyone who started saving 40 years ago, when the postwar "baby boom" generation was just joining the workforce, has found that stocks have performed no better than 20-year government bonds since then, a forthcoming article by Robert Arnott for the *Journal of Indexes* shows. These people want to retire soon and the "cult of the equity" has let them down.

To find a period that does produce an outperformance requires a span reaching back a lot further. The 2009 Credit Suisse *Global Investment Returns Yearbook* shows that since 1900 US stocks have averaged an annual real return of 6 per cent, compared with 2.1 per cent for bonds - while in the UK, equities have beaten gilts with a return of 5.1 per cent against 1.4 per cent. The problem is that they can perform worse than bonds for periods longer than a human working lifetime.

Further, recent experience challenges that basis of modern finance, the "efficient markets hypothesis", which in its strongest form holds that prices of securities always reflect all known information. This implies that stocks will react to each new piece of information, yet without following any set trend - a description that cannot be applied to the events of the past 18 months. On these foundations, theorists worked out ways to measure risk, to put a price on options and other derivatives and to maximise returns for a given level of risk.

This theory also showed that stocks would outperform in the long run. Stocks are riskier than asset classes such as government bonds (which have a state guarantee), corporate bonds (which have a superior claim on a company's resources) or cash. So the argument was that those who invested in them would in the long run be paid for taking this risk by receiving a higher return. That is now in question.

"There's no such thing as a risk that you get paid for taking. The whole point about risk is that you don't know if you're going to be paid for it or not," says Robert Jaeger at BNY Mellon Asset Management. "What's important about the current period is that now it's true even for a very long period [that] people haven't been paid for taking equity risks. These losses were taken by people who didn't even think they were taking a risk."

"It supposedly didn't matter how long you waited. But the notion that the long run will bail you out no matter what stupid things you do in the short run I think is dead," says Robert Arnott, who examines such performance in a forthcoming article for the *Journal of Indexes*. "And the notion that if you have the better asset class it doesn't matter what you pay for it is on its deathbed."

Instead, the cult of the equity and the efficient markets hypothesis begin to look like phenomena born of the uniquely positive conditions in the middle of the last century. For decades until 1959, the yield paid out in dividends on stocks was higher than the yield paid out by bonds. This was to compensate investors for the extra risk involved in buying equities. In 1951, as the building blocks of the efficient markets theory began to appear in academic journals, US stocks yielded as much as 7 per cent, compared with only 2 per cent on bonds.

"The 1950s marked the start of a period of relative peace and prosperity. It came on the heels of a tumultuous 50 years that included two world wars and an economic depression. In hindsight, the case for equities over bonds was especially compelling in the early 1950s," says Robert Buckland, chief global equity strategist for Citigroup.

So in 1959, the yield on stocks dipped below the yield on bonds - and stayed there for almost half a century until the two crossed once more last November. The theory changed to account for this and came to hold that bonds yielded more to recognise the superior long-term growth potential of equities.

That growth potential made pension funds boost their allocations to equities. In the US, and later elsewhere, legislation gave individual investors more power over their retirement funds but also required them to take on the risks. As employers were no longer guaranteeing them a proportion of their final salary on retirement. Savers' money went heavily into equities. Then came the bear market of this decade.

If that bear market has damaged the case for stocks, the efficient markets hypothesis underlying it had been "dying a natural death for most of this decade", according to Mr Arnott. In place of the standard assumption that all decisions are rational, behavioural economists began substituting findings from experimental psychology on how people actually make decisions. This helped to explain market crashes and bubbles, showed that investment decisions could be systematically irrational and led to attempts to create new models of how markets set prices.

Efficient-markets theorists themselves moved away from the hardest version of the theory. They identified two anomalies: in the long run, small companies tend to outperform the larger, while cheap or "value" stocks (which have a low price in relation to their earnings or the book value on their balance sheet) outperform more expensive stocks.

Burton Malkiel, a Princeton economics professor whose book, *A Random Walk Down Wall Street*, is the most famous statement of efficient-markets theory, suggests its strongest form is a straw man. " 'Efficient markets' has never meant to me that the price is always right," he says. "The price clearly isn't right. We know markets overreact. They get irrationally exuberant and they get irrationally pessimistic." But he says that the key implications remain intact. "What 'efficient markets' says is that there are no easy opportunities for riskless profit. There I still would hold that that part of the efficient markets is alive and well."

Still, the search is on for a new theory to replace efficient markets. Perhaps most prominently, Andrew Lo, head of the Massachusetts Institute of Technology's Financial Innovation Laboratory, has merged behavioural and efficient markets theory using Darwinian biology.

In his "adaptive markets hypothesis", markets behave efficiently during periods of calm. "Periods of extraordinary prosperity have behavioural effects - it gives us a false sense of security and therefore there is too much risk-taking. Eventually that kind of risk-taking is unsustainable and you get a burst of the bubble."

Once bubbles burst, Mr Lo's theory predicts, a period of "punctuated equilibrium" will ensue, in which longgrained behaviours no longer work. "We just had a meteorite hit us in financial markets. There will be destruction of species that have lasted a very long time. Out of the chaos will emerge new species."

Most clearly, the lightly regulated hedge fund industry - described by Mr Lo as the Galapagos of financial services - is suffering a shake-out. The sector as a whole suffered an average loss of 18.3 per cent last year, only its second losing year since 1990, according to Hedge Fund Research of Chicago. This prompted investors to pull \$155bn (£115bn, £105bn) out of the funds. But the worst performing 10 per cent lost an average of 62 per cent, while the top decile gained 40 per cent. The Darwinian process is well advanced: 1,471 hedge funds were liquidated last year, while only 659 new ones were launched, the lowest figure since 2000.

The traditional mutual fund, in which managers run a portfolio of about 100 stocks and attempt to beat a benchmark index, may be another casualty. Last year, most equity mutual funds failed to beat their benchmark indices, even though their managers had the freedom to move into cash and to pick stocks. Mr Malkiel points out that of the 14 funds that had beaten the market in the nine years to 2008, only one did so last year. Both efficientmarkets and behavioural economists say it is better just to match the index, with a tracking fund, and avoid the fees incurred in unsuccessful attempts to beat the market.

Index funds have caught on over the last two decades and, recently, their growth has been driven by exchange-traded funds - index funds that can be bought and sold directly on an exchange. Mutual funds saw global net sales of \$112bn last year but ETFs pulled in a net \$268bn, according to Strategic Insight, a New York consultancy. Barclays Global Investors reckons there are plans to launch another 679 ETFs around the world.

Index funds could become building blocks for new retirement savings products that may look much like the pensions that were the norm until confidence in equity investing took over. As it may be politically infeasible to continue to expect savers to bear all the investment risk, some benefits may have to be guaranteed.

Mr Lo suggests that all these developments are consistent with a new world in which investments will largely be controlled by "herbivores" - funds that passively aim to match benchmark indices for a range of asset classes that goes beyond equities. This leaves room for a smaller group of "carnivores" to try to beat the market by exploiting inefficiencies and anomalies.

Those carnivores will, moreover, be putting much less trust in theoretical models. As Mr Jaeger says: "Even with all those quantitative models, ultimately you have to make a decision. Ideally, what you are left with is people doing that somewhat old-fashioned kind of investing where you try to figure things out for yourself."

## 'I haven't opened a statement for months: there's no point in depressing myself'

Christina Read is 61 and, at least on paper, has lost half her life's savings in the past year. "I started last year with about \$400,000 - it's down to I think about \$200,000 now," says the former dancer who now works as a nanny in Manhattan.

For Ms Read, who is divorced with two college-age children, the loss means giving up her dream of a house in the country. "I had been thinking of an old farm, maybe in Nova Scotia. Now it is pretty much impossible."

But she is retaining the investments that have performed so poorly: "I will continue working, I have to keep money coming in now and, if the market doesn't come back in the next 10 years, I will give up on having anything for myself - I will just leave it to my children."

It is this kind of stoicism that has the army of brokers, wealth managers, fund managers and product marketers who grew rich during the boom hoping individual investors will get back into the markets, and soon. Unless they do, the industry's outlook will be dire. Retail investors, mainly through mutual funds, own a much larger part of the stock and bond markets than ever before. Bob Reynolds, chief executive of Putnam Investments, says: "It started out with 401(k)s [individual retirement accounts]. There are more mutual funds than stocks. We are an investor society."

Will it stay that way? Ms Read may have sat tight but hers was not the only response to the world-shaking events. In the biggest ever exodus of money from professional management, Americans pulled a net \$320bn (£218bn, €237bn) from mutual funds last year. They shifted into cash, ploughing a net \$422bn into money market funds during the year. A net \$212bn went into bank deposits - a figure that has since risen further, to \$370bn for the 12 months to mid-March.

Elbowing aside their advisers, some began trading their stocks themselves, sharply lifting retail trading volumes as they tried to take control of their investments. Others have done nothing, but for different reasons than Ms Read. Hearing the bad news, they have simply refused to open their financial statements.

"I haven't opened a statement since October," says one Los Angeles-based business owner, who adds that his holdings were worth more than \$3m at the end of 2007 but declines to estimate their value now. "I know it's bad, but what can I do about it? There is no point in depressing myself. I need to focus on my business, which is going well. My investments are probably pretty much gone . . . I had a lot of stocks - bank stocks, Bear Stearns, they're gone. I see the statements come in the mail and I throw them right in the garbage."

George Gatch, chief executive of JPMorgan Funds, an arm of JPMorgan Chase, is working to re-engage with such investors. "We know how scared people are and we are trying to convince people to get back in, sit down and talk to their financial advisers," he says. The 50,000 advisers with whom JPMorgan works are reporting that "it is very hard to get their clients to consider the steps they should take, to do a formal review of their portfolio . . . There is a base of Americans that don't want to look at their statements any more."

More than 90m Americans own stocks, through mutual funds and 401(k) plans. But Mr Reynolds adds: "There is a tremendous amount of cash on the sidelines today. Retail investors have close to \$13,000bn sitting in money market funds and bank deposits. A year ago there was \$7,000bn. That is billions that is just waiting to come back again."

In other words, retail investors have the wherewithal to get things working. The question is whether they will. "The demographics and people's objectives haven't changed because of the market," says Mr Reynolds. But, like others, he sees a shift to more conservative investing.

Independent financial advisers who work outside the big brokerage firms tend to be more pessimistic.

"Once the money gets under the mattress, which it has, it takes a long time to pry it out again," says one.

If individual investors stay away, the consequences for the lucrative wealth management industry and its associated services and advisers are considerable. Wealth management is seen as a stable source of revenue for the Wall Street banks as they restructure themselves for a new era.

For instance, Citigroup and Morgan Stanley are merging their wealth management operations, which will result in an army of more than 20,000 brokers to compete with Bank of America's new "thundering herd", previously part of Merrill Lynch.

Jim McCaughan, chief executive of Principal Global Investors, an asset manager, says he does not see a shift away from using brokers or advisers: "Fear tends to lead people to want to talk to someone. They will go to the advisers and brokers: that is what has happened in past bear markets."

First, however, investors will need to start looking at their financial statements again.

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