In a Withering Market, Where Will Your Investments Grow?

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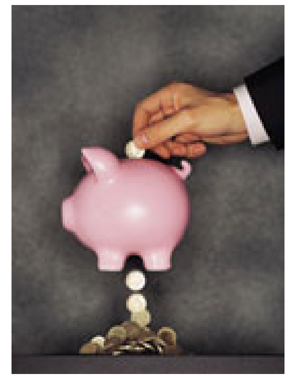

For many investors, building wealth today feels like ascending an M.C. Escher staircase: The path going up is suddenly going down. After losing equity in their homes and stock portfolios, Americans are now scrambling to make up lost savings. Seeking both yield and security in an uncertain economy, many are moving money out of stocks and into bonds. They are also flooding into emerging markets, high-yield corporate debt, gold and a host of other investments once considered either risky or unattractive to the typical investor.

The shifting investor behavior is dramatic in the short term, but unlikely to have a long-term impact on the economy, Wharton experts say. Long term, the federal government's actions on interest rates, taxes, health care and the deficit will have a far broader influence. On the other hand, the new investment strategies could have a profound effect on individual investors themselves, some of whom may not realize the risks they are taking. Like figures trapped in Escher's lithograph, they are unknowingly walking a circular path -- and may be headed towards another descent.

Many observers point to the Federal Reserve's interest rate policy as key to investors' changing preferences. The Fed has held the federal funds rate near zero since December 2008 in an attempt to stimulate economic growth. The federal funds rate influences other interest rates, such as the prime rate and interest rates on certificates of deposit, making it cheaper for consumers and businesses to borrow.

On the flip side, the low interest rates also make it difficult to save. With yields on CDs and money market accounts dwindling, risk-averse investors are searching for alternative ways to build wealth. Wharton real estate professor Peter Linneman says that some are dipping a toe back into real estate. "As long as the Fed keeps short rates at zero, investors are searching for seemingly safe yield," he notes. "This is pushing them into many other assets, including real estate. It is creating a false demand for these assets, which will fall when the Fed eventually, and belatedly, raises rates. Meanwhile, it means that prices for relatively solid real estate cash flows are stronger than [they] should be, given the strength of occupancy and rents."

The rising investor interest in corporate debt is another result of the low interest rate environment, says Wharton finance professor Franklin Allen. As corporate default rates have declined, investors have snapped up corporate bonds, including high-yield junk bonds -- that is, debt issued by companies with low credit profiles. "It's one of the few places you can get yield at the moment," he notes.

Bringing interest rates back up won't be easy for the Fed, Allen adds. The Fed is hesitant to raise rates because that could put pressure on a fragile economy just as it begins to recover. "The problem is that if the Fed raises the interest rate, many firms will need to pay more in interest. The weaker ones will not be able to do that and will go bankrupt. Their workers will be laid off and unemployment will go up." He believes the United States is at risk of stagnating like Japan did during its "lost decade" of the 1990s. "You get stuck in just worrying about the short term.... It's a very difficult trap to get out of."

The 'Bond Bubble'

As Americans watch their net worth tumble, low interest rates are not enough to convince them to borrow and spend. Consumers are plowing a greater percentage of disposable income into paying down debts and replenishing lost equity. According to the latest report by the Federal Reserve, household net worth -- the difference between the value of assets and liabilities -- fell 2.8% in the second quarter. As of July, households were saving close to 6% of disposable income, and household debt had fallen to 119% of disposable income, down from a peak of 130% in September 2007.

"The problem, of course, is that wealth dropped in value. So the savings rate jumped," says Wharton finance professor Nicholas S. Souleles. "Housing wealth went down, stocks went down, many people lost their jobs or felt at risk of losing their jobs.... Expectations of future income went down, and the risks to future employment and security went up. All those led people to save more and borrow less. There's also the supply side component to this: The banks aren't lending, and credit card companies are reducing lines of credit."

With stock volatility up and yields on money market accounts down, investors have moved into bonds and other investments. According to the Washington, D.C.-based Investment Company Institute, the national association of U.S. investment companies, $515.6 billion flowed out of money market funds from January to July 2010, and $29.6 billion flowed out of domestic equities. At the same time, investors pumped $185.6 billion of new cash into bond funds and $27.9 billion into international equities.

Souleles wonders if investors are aware of the risks of some of their new investments. Do all newcomers to the bond market realize that bond prices and interest rates move in opposite directions? When interest rates go up, bond prices will drop. "The point is, you can't assume that these are safe stores of value," Souleles says. "And ironically, although people seem reluctant to move into [domestic] stock, [they] are moving into emerging markets ... [which are] traditionally much higher risk. It's unclear how much people appreciate that. Are they just chasing returns? Or is this more deliberate?"

Wharton finance professor Jeremy Siegel believes investors into U.S. Treasury bonds could be in for a fall. "Those who are now crowding into bonds and bond funds are courting disaster," Siegel wrote in an op-ed published in *The Wall Street Journal* in August titled, "The Great American Bond Bubble." Written in conjunction with Jeremy Schwartz, director of research at WisdomTree Investments where Siegel is a senior advisor, the article warned of what would happen to bond funds when interest rates rise: "The possibility of substantial capital losses on bonds looms large. If over the next year, 10-year interest rates, which are now 2.8%, rise to 3.15%, bondholders will suffer a capital loss equal to the current yield. If rates rise to 4% as they did last spring, the capital loss will be more than three times the current yield. Is there any doubt that interest rates will rise over the next two decades as the baby boomers retire and the enormous government entitlement programs kick into gear?"

Siegel says critics objected to the piece, arguing that investors who hold bonds to maturity will always receive a specific dollar amount, making bonds inherently less risky than stocks. But most Americans are not actually buying bonds, he points out. Rather, they are investing in bond *funds*. Rather than holding bonds until they mature, bond funds sell bonds as they get close to maturity and replace them with similar bonds that will mature at a later date. "These people who are going into bond funds are not holding them until maturity," Siegel notes. "If interest rates rise, they will take a permanent loss in their portfolio."

According to Siegel, stocks are "very good bargains right now for people who are willing to take on extra risk." He says commodities like gold might continue to go up in the short term, but "gold has never been a good long-term investment."

'Giving up' on Volatility

Wharton finance professor Richard Marston, director of the Weiss Center for International Financial Research, says the shift that retail investors are making from stocks to bonds "will have some impact on the economy. If people don't invest as much in stocks, that will keep the stock market relatively depressed" and slow the economy down. "But I think the greatest impact is on the individual investors themselves."

He notes that large institutional investors, such as endowments and pension plans, are still maintaining a diversified portfolio of domestic stocks, foreign stocks and fixed income investments. In a 2009 Greenwich Associates survey that appears in Marston's forthcoming book, *Portfolio Design*, the average investments of pension plans allocate 27.5% to fixed income, 32.2% to U.S. stock and 15.1% to foreign stock, among other investments.

In contrast, many individual investors have pulled out of stocks entirely --- a strategy Marston doesn't recommend. He suggests people keep 50% of their portfolio in stocks and 50% in bonds after retirement, and worries that the new bondholders are not fully thinking through their position.

"Because of the decline of the stock market, many investors are reducing if not eliminating their stock market positions. This is a more serious problem," says Marston. "Investors who have given up on volatility are going to have to settle in and live on bond returns ... [Government] bond returns, in the long run, have an average return adjusted for inflation of 2% to 2.5%. If investors have saved so much money that they can settle into bonds, that's great news for them. But most Americans haven't."

The shift away from equities may show that investors have become more aware of the stock market's inherent risks, says Wharton finance professor Marshall E. Blume, director of the Rodney L. White Center for Financial Research. "Up until recently, many investors thought that the stock market was a gold mine with no risk. The last couple of years have shown that the stock market has a lot of risk.... Individuals are realizing that they have to be more prudent."

The federal government, he adds, is having a far larger impact on the economy than individual investment decisions. Businesses remain unclear on the costs of health care reform, the details of new financial regulations, or the long-term impact of the federal government's deficit spending -- all contributing to a jittery stock market and a sluggish economy. "There's so much uncertainty out there," Blume says. "The federal government itself has created significant shifts."

In the long run, though, Blume predicts that individual investors will return to investing in stocks "when they see they've done well." His research suggests that investors should hold a balanced portfolio with about 40% bonds and 60% stocks. In reality, though, "many investors just follow the latest trend," he notes.