

COVER STORY

Despite the rally, investors are still very concerned about preserving their capital. So how can they make their wealth grow?

Just Don't Lose It!

By Kopin Tan

When stocks recently hit a six-month high, U.S. Trust's chief investment officer, Christopher Hyzy, expected to hear from investors eager to buy more shares. Instead, calls came in from clients who wanted to know if they should take profits, or how they could protect their winnings following the Standard & Poor's 500's quick 20% jump to break through 1300.

It's not just U.S. Trust investors who are cautious. Across the country, employers are gradually adding jobs, and fears of a double-dip U.S. recession have receded momentarily—enough to propel U.S. stocks up 4.7% in January, double their gain from a year ago. Yet financial advisors and money managers are listening to the same anxious refrain from their clients: Make sure you don't lose our money! Investors may be resigned to diminished returns, what with bond yields plumbing historic depths and banks paying almost no interest, but their biggest priority remains to avoid, at all cost, a repeat of the 2008's disastrous losses.

Can you blame them? The markets are in the throes of Europe's solvency crisis, and gripped by policy paralysis following the bursting of Earth's debt bubble. The messy demise of MF Global—with billions of client money still missing—com-

ing so soon after the Bernie Madoff scandal further reinforces the suspicion that our fragile financial system is a house of cards.

And after rallying 25% in 2009 and 12% 2010, it felt ominous when the three-year-old bull market ended 2011 back where it started, but with gut-wrenchingly feral swings along the way.

This blow to sentiment could affect everything—from who runs our government, to the next generation's view of risk, to the length and strength of stock-market rallies. And it raises tough investment questions. Can you preserve your capital at today's low interest rates and still preserve your standard of living, when prices for many essentials—gas, meat, prescriptions, Prada loafers—are climbing much faster than the official 2.2% core inflation rate? Is this new cautiousness obscuring the stock market's long-term value? Are there investments that will help your returns without too much risk?

Even the current rally has been met with unease and skepticism. Over the first four months of 2011, long-term investors had begun steering more money into stock-mutual funds than bond funds. Then the euro crisis escalated, and the U.S.'s triple-A credit rating was taken down a peg. Since then, investors have changed course, yanking more than \$163 billion

from stock funds and plowing \$92 billion into bonds. Overall, 2011 saw the biggest flight from stock funds since 2008 and suffered the second-worst annual exodus of the past 27 years. That funk lingers: Trading volume was down 25% across equities, credit, commodity and government-bond futures as 2012 began.

Consider other ways in which investor psyche is dented:

- A recent survey conducted by Investment News found just 43.6% of financial advisors planned to increase their clients' allocation to stocks this year, down from 63.4% at the start of 2011, when the government's quantitative-easing campaign was lifting spirits and stocks.

- A survey by the Yale School of Management showed a marked decline among investors who felt confident there wouldn't be a stock-market crash over the next six months. The outlook was especially grim among individual investors, who seemed as worried about a crash as at the height of the financial crisis. "Things in the U.S. aren't nearly as bad now as they were back in 2008 and early 2009, but don't try and tell the retail investor that," says Justin Walters, co-founder of Bespoke Investment Group. "They're truly spooked."

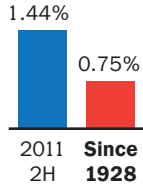
- Notwithstanding the downgrade of U.S. debt, investors bent on capital preservation are buying enough Treasuries to drive the benchmark yield on 10-year

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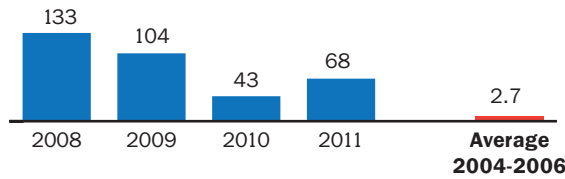
A Show of Nerves

Investors' fear of losses was exacerbated when stocks ended 2011 where they started, but with huge price swings in between.

S&P 500 Average Daily Move



Number of Days when S&P 500 moved more than 2% up or down within one session

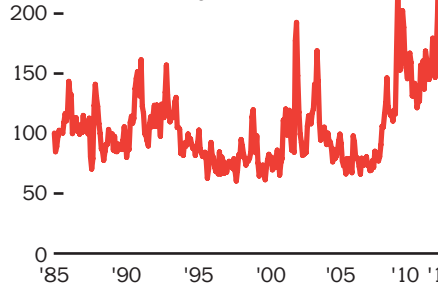


Sources: S&P; Goldman Sachs Derivatives Strategy

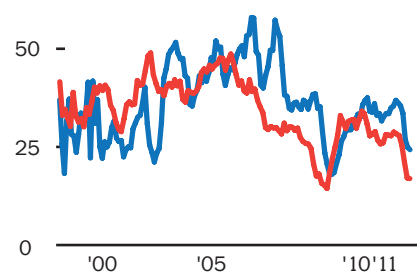
The torrent of headlines about Europe's debt crisis and the U.S. credit-rating downgrade recently drove an index measuring policy-related economic uncertainty to a new high...

...and a Yale index that tracks investors' confidence that the markets can avoid a crash in the next six months dipped sharply, especially among individual buyers...

Economic Policy Uncertainty Index



Crash Index-Institutional vs Individual



Sources: Scott R. Baker and Nicholas Bloom (Stanford), Steven J. Davis (U of Chicago); Yale School of Management

Coming after a rare decade of price declines in the S&P 500 that helped spawn two recessions, and high-profile wipeouts from Madoff to MF Global...

	1930s	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2011
Price Appreciation	-5.26%	2.98%	13.57%	4.39%	1.60%	12.58%	15.31%	-2.72%	0.00%
Returns from Dividends	5.59	5.95	5.63	3.33	4.12	4.77	2.82	1.76	2.11
Total Return	0.33	8.93	19.20	7.72	5.72	17.35	18.13	-0.96	2.11

Sources: Bahl & Gaynor, Ned Davis Research, Bloomberg

2011 saw the most money fleeing U.S. stock funds since the 2008 crash, and the two became the worst years of the 21st century...

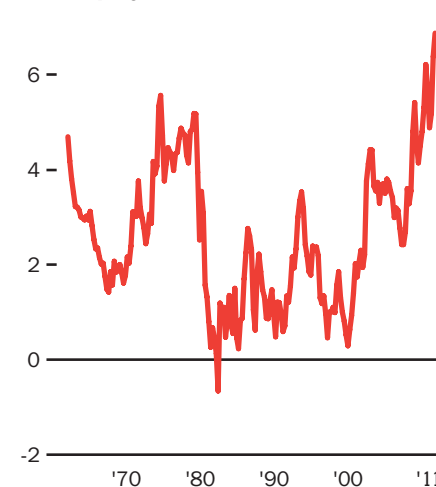
That drove the equity risk premium—the amount investors demand in order to own stocks over risk-free assets—to the highest level in decades.

Year	U.S. Equity Funds (mil)	Total Bond Funds (mil)
Annual Average 1990-1998	\$99,331	\$27,193
1999	\$176,341	-\$4,081
2000	261,381	-50,042
2001	54,509	87,878
2002	-26,228	141,525
2003	119,988	33,089
2004	100,984	-10,921
2005	18,018	31,166
2006	290	60,428
2007	-64,709	108,318
2008	-147,496	29,542
2009	-27,711	380,417
2010	-94,663	241,397
2011*	-131,652	128,482

*Includes December data, which is estimated.

Source: ICI

Equity Risk Premia



Source: JPMorgan Equity Strategy

notes to below 2%. In Europe's strongest economy, Germany, the 30-year bund last week paid its lowest yield since the euro's inception. Things won't change anytime soon, and the Federal Reserve last week promised to keep rates near zero for three more years.

- Of more than 300 new exchange-traded funds launched in 2011, the two most popular by far were conservative strategies that steered investors toward stability and capital preservation. The iShares High Dividend Equity Fund (ticker: HDV) ended 2011 with a whopping \$920 million in assets, notes Neil Leeson, Ned Davis Research's ETF strategist, while the PowerShares S&P 500 Low Volatility Portfolio (SPLV) racked up \$866 million since its May launch.

- President Obama ended his third year in office with a 43% approval rating, the lowest of any president since Jimmy Carter—a sign Americans aren't too confident the administration can rouse our listless economy.

- Risk aversion is particularly acute among "Generation Y" investors born after 1980, who have decades to go before they retire but are especially reluctant to invest. These young adults "reached investing age during the dot-com bust, lived through the 2008 great recession and continue to experience significant economic uncertainty and market volatility," says William Finnegan, senior managing director at MFS Investment Management. In a survey the firm conducted last fall, 40% of Gen Y investors agreed with the statement "I will never feel comfortable investing in the stock market." Nearly a third said their primary investment objective was to protect their principal. As a result, this cohort allocates roughly 30% of their money on average to cash, more than any other age group.

Because of the still-substantial macro risks—Europe's systemic debt crisis, a potential hard landing in China, and fiscal tightening in the U.S.—many strategists say the short-term outlook for stocks remains murky. As a result, the equity-risk premium—the amount investors demand to own stocks compared to traditionally risk-free assets like Treasuries—has recently climbed to its highest level in decades.

"Does it make sense that equity-risk premia are higher today than at any other time in the last 60 years?" asks Thomas Lee, JPMorgan's U.S. equity strategist. At the very least, this suggests stocks are undervalued, Lee says. History shows that at times like these, stocks can produce above-average returns even when economic growth is subpar, since

the “cheaper valuation gives stocks a larger margin for error,” Lee notes.

But persuading Americans to buy will be a challenge. At the heart of the problem is the chilling specter of countries possibly going bust, which became more likely after governments bailed out the private sector and took on much of their debt. Until 2011, there was a well-entrenched notion of a risk-free rate, which was “built on the sanctity of developed countries’ sovereign-debt markets,” says Nicholas Colas, chief market strategist at ConvergEx Group. But that bedrock principle has since been reduced to rubble after our debt-ceiling debate introduced the possibility that the U.S. might miss a coupon payment, and credit agencies took to slashing sovereign ratings. In Europe, a monetary union without fiscal unity is proving to be a disaster; while in China, investors fear that aggressive lending has merely swapped a prolonged recession for a looming property bubble.

Not surprisingly, an index measuring economic-policy uncertainty tracked by professors at Stanford and the University of Chicago recently jumped to an all-time high. Things may not improve anytime soon. Citigroup’s London-based economist Michael Saunders expects a credit downgrading of the U.S., Japan, France, Italy, Spain, Austria, Belgium, Finland, Ireland, the Netherlands and Portugal over the next two to three years

This long, messy rehabilitation of the debt-scarred global financial system has overshadowed U.S. companies’ stalwart earnings, record cash holdings and reasonable valuation, with large-cap U.S. stocks trading at just 13 times projected profits, well below their median of 15.7 times over the past decade.

Such competing—and compelling—buying and selling impulses have trapped the market in a violent tug of war that has frightened investors. Last year saw 68 sessions where the Standard & Poor’s 500 jumped or fell more than 2% within one session. In contrast, there were just two such days in all of 2005. Last year also produced a record 70 days when nearly every single stock seemed to rise or fall at once—so-called “all or nothing” days when advancers or decliners within the S&P 500 outnumbered the other camp by more than 400. In contrast, there were just 67 such days over the 15 years from 1990 to 2004. This wreaked havoc with the long-cherished principle that investors can minimize risk with diversification and by holding a variety of stocks.

It didn’t inspire investor confidence that professional traders also struggled mightily. Roughly 48% of money managers trailed their respective benchmarks by 2.5 percentage points or more in 2011—the worst annual record since 1998, according to JPMorgan. The results were particularly dismal among large-cap growth funds, where an astounding 70% trailed their benchmarks by 2.5 percentage points or more.

Coming so soon after a lost decade of returns, investors can be forgiven for fretting about their investments. Hobbled by the bursting of the tech and debt bubbles, the S&P 500 ended the 2000s with a total return of -0.96%, the worst decade since the 1930s’ 0.33% haul, and a cruel decline from 17.4% during the 1980s and 18.1% over the 1990s.

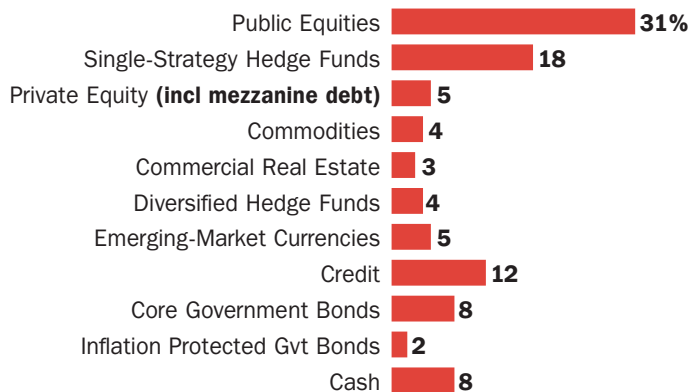
Stocks’ recent showing would have been worse if it weren’t for boring dividend-paying companies, which provided all of last year’s 2.1% return and made a positive contribution in the 2000s. That’s quite a shock for boomers. In the 1990s, for example, dividends’ 2.8% return was overshadowed by rallying stock prices, which added 15.3%.

No surprise, then, that investors are flocking to cash-rich, yield-paying companies, which many believe might be more stable and less risky in a volatile market. Cincinnati-based Bahl & Gaynor, which has focused on higher-quality dividend-paying

Spread Your Bets More Broadly...

Corporate bonds, which offer more variety, are a way to diversify beyond sovereign debt. Alternative assets and non-traditional funds also can be used to round out a substantial individual portfolio.

JPM's US Balanced Portfolio for Wealthy Individuals*



*With more than \$25M in assets

Source: JPMorgan Private Bank

And Keep Some Cash for Opportunities

U.S. Trust’s suggested current and long-term allocations.

A Model Balanced Portfolio	Tactical Target*	Long-term Benchmark
CASH	5%	0%
EQUITIES	42	42
U.S. Large Cap	20	16
U.S. Mid-Cap	7	7
U.S. Small Cap	4	4
International Developed	4	9
Emerging Market	7	6
FIXED INCOME	28	30
U.S. Investment Grade	20	25
International Developed	0	2
U.S. High Yield	8	3
Hedge Funds	12	12
Private Equity	6	6
Real Estate	1	4
Tangible Assets	6	6
Total	100%	100%

*For 12-18 months

Source: US Trust

stocks since 1990 and has trademarked the phrase “Dividends pay dividends,” last year saw assets under management leap to a record \$5.1 billion—from \$3.2 billion in 2010.

“Baby boomers burnt by recent crashes are anxious not to relive 2008,” says Matthew McCormick, a Bahl & Gaynor portfolio manager. But the traditional ways for investors to preserve their capital—by clinging to cash or buying government bonds—are now rendered quixotic by interest rates near zero and Treasury yields plumb fresh hells.

Detractors argue that the zeal for dividends has become a crowded trade, but McCormick disagrees. Demand for stable dividend payers is supported by demographic trends, what with

the horde of baby boomers nearing retirement age and looking for income that can keep pace with inflation. “Healthier corporate balance sheets, with more cash on companies’ books, also mean companies are better positioned to pay or increase dividends,” he says. “Besides, padding dividends is about the only way for corporate insiders to give themselves a raise without catching political flak.”

Bahl & Gaynor screens for companies that pay a yield of at least 2%, and that have raised their dividends in at least two of the past five years. The firm then scours companies’ fundamentals to get a portfolio with an average market cap of \$56.1 billion, an average yield of 3.7% and 8% average dividend growth over the past five years. Its top holdings include McDonald’s (MCD), Philip Morris (PM), Abbott Laboratories (ABT), Intel (INTC), Bank of Nova Scotia (BNS), Oneok (OKE) and Bristol-Myers Squibb (BMY).

While safer dividend-payers have lagged behind riskier assets in January’s rally, Jack Ablin, chief investment officer at Harris Private bank, thinks they will remain crucial. More than 7,000 Americans hit their 65th birthdays each day, and their ranks will swell from 13% of the population now to about 18% by 2030. Dividends have accounted for nearly half the S&P 500’s annualized total returns over the past 84 years, and Ablin expects “the income component will continue to play a vital role in equity returns over the long term.”

Hyzy of U.S. Trust, which is Bank of America’s private-wealth unit, also believes in “being paid to wait while the market repairs itself.” The credit crisis has brought a new paradigm, where the world is trying to repair the bloated debt structure of recent decades. This process takes time, and the investment environment will remain fragile. Until policy makers manage to produce lasting results, instead of merely kicking the proverbial can down the road, “we believe we’re facing another year of bouts of sharp volatility, dictated once again by a policy-heavy climate.”

Among other things, Hyzy thinks the S&P 500 could finish 2012 between 1325 and 1350, within a hair of last week’s levels, and recommends paring risk when the index approaches the upper end of its range. (U.S. Trust, for example, trimmed its suggested allocation to stocks from overweight to neutral this month when that occurred.) Hyzy also suggests putting some money toward diversified, multi-strategy hedge funds, since they have more tools for betting against the market, beside just going to cash. In the face of persistently low rates, he also suggests deploying a “crossover strategy” with bonds that includes allocating money to corporate debt (both investment-grade and high-yield), other fixed-income assets (including municipal, mortgages and agencies), and diversifying beyond U.S. and European sovereign bonds to include countries-like, say, Canada and Norway—that have strong currencies and steeper yield curves.

With yields depressed as long as global growth is slow, Rebecca Patterson, JPMorgan Asset Management’s chief market strategist, also suggests looking to higher-yielding assets like emerging-market and corporate debt as well as equities. There are also “alternative assets” like mezzanine debt, which may be less liquid but pay a longer-term return of about 7.5% and are less correlated to global risk-on, risk-off flights.

Now that 2011 has destroyed the notion of a risk-free interest rate, how long before global central banks and sovereign wealth funds realize the need to diversify away from their vast stockpiles of sovereign bonds? After all, the world has only 200 or so issuers of sovereign debt. Less than two-thirds of these are rated by Moody’s or S&P, often based on subjective criteria like political risk, and five of them alone—the U.S., U.K., Japan, France and Germany—make up 77% of the \$21 trillion Barclays Global Treasury Index. Compared with this rather limited choice, corporate bonds are issued by thousands of companies that are rated on more transparent yardsticks like their balance sheets. “The events of 2011 opened the door to thinking about sovereign risk as a species of credit risk,” Patterson argues, and this sets the stage for a gradual, long-term shift from sovereign to corporate bonds.

Investors, too, should start rethinking what constitutes a safe, productive portfolio. ■