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PERSONAL FINANCE

Don’t hate equities; they are a long-term ally

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American investors seem to have a hate relationship with stocks in recent years.

This should come as no surprise to those following the markets — individuals have been selling stocks for the better part of the last six years. The selling started in April 2007 and has steadily continued in spite of U.S. equity markets doubling from their lows of 2008.

The genesis of the current trend to avoid the stock market seems to be based, oddly enough, on real estate. Before the recession and the collapse in real estate prices, it seems that many investors chose to continue to expect the four decade long bull market in real estate to continue. As we know now, it didn't. As well, there was a related high comfort level with bonds, based on attractive risk-adjusted returns compiled during a bull market.

Those investors were hit with a double whammy as the S&P500 plunged by 38 percent in conjunction with significant declines in housing values beginning in 2008. Investors quickly reevaluated their tolerance for risk.

These behaviors, commonly known as the "snake bite effect" and "recency bias" by behavioral economists, cause individuals to narrow the information they use in making decisions to their own experiences. Although personal experience is valuable, the exclusion of critical data from financial decision-making processes can — and typically does — prove detrimental to our financial well-being.

The average American investor's track record with both stock and bond investments can explain the current level of frustration market participants are experiencing. We all know investors have been voting with their feet. Bank accounts and money market funds currently are holding $10 trillion of investors' assets — despite returns lower than the level of inflation. Additionally, investors have sold $380 billion of stocks and bought $1 trillion of bonds since April 2007. These decisions about stocks are being made in an environment where U.S. corporations, controlled by those individuals possessing the best information about these companies, have been buying back their own stock and increasing dividends at a healthy pace.

A look at the Quantitative Analysis of Investor Behavior (QAIB), an annual study conducted by Indiana University, sheds some light on why Americans currently are comfortable with constructing their portfolios in a manner seemingly inconsistent with their long term needs. This study showed the average annual rate of return of a mutual fund owner as 2.1 percent during 1992-2011. This compares to the S&P500's annual return of 7.8 percent and the Barclay's Aggregate (a broad based bond index) annual return of 6.5 percent over the same time period. These types of subpar returns can prove to be catastrophic and frustrating to any long term investment plan.

With current talks of cuts in entitlement programs (i.e., Social Security), increasing life expectancies, interest rates at all-time lows and the continuing trend away from traditional pension plans, now more than ever investors need to be mindful of the purpose of the portfolio they are constructing.

Portfolios are typically built with the idea of funding future liabilities. These liabilities may include college tuition, retirement, or unexpected emergencies. As investors assemble their portfolios, they need to be aware of three critical factors: investment time horizon, withdrawal needs, and tolerance for risk. Typically, the most difficult to assess of these is one's tolerance for risk as it can change through a market cycle.

We all seem to love risk when it is rewarding us and loathe it when it is punishing our portfolio. This explains one of the big stumbling blocks investors have with owning stocks: dealing with the variability of returns. Historically, stocks have exhibited a significant range of returns, with 95 percent of yearly returns falling somewhere between approximately — 20 to + 40 percent. With this variability — or risk — have come attractive returns for long term investors holding well diversified portfolios. Those investors capable of looking beyond the market's ever present short-term gyrations may want to consider adding stocks to their portfolios in a constructive and disciplined manner.

Positive corporate earnings growth alongside an expansion in the price-earnings ratio of solid companies should drive strong equity returns in 2013 and in 2014.

The general public's current disdain for owning stocks may prove to be a smart entry point for those understanding and accepting the risks that have accompanied the attractive returns stocks have produced.

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