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Past Turmoil Leaves a Lasting Impression on Today's Investors

By Paul Sullivan

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If there was one word that applied to investing this year, it was uncertainty.

But there were different kinds of uncertainty. To paraphrase Donald Rumsfeld, the former defense secretary, this year there were uncertain uncertainties and certain uncertainties. Some of the uncertain uncertainties were the European debt crisis, China's handling of its stalled growth and leadership transition, and the presidential election in the United States.

The fiscal-cliff negotiations were a certain uncertainty. No one I spoke to throughout the year thought the talks would be concluded in a tidy fashion with weeks to spare, and they were certainly right.

"There has been a lot to worry about this year," said **Gregg Fisher**, president and chief investment officer of **Gerstein Fisher**, a wealth management firm in New York. "The other problem with uncertainty is we're worried about what other people are worried about. This creates a huge amount of uncertainty without a path."

Despite the worry, stocks in the United States had a good year, with the Standard & Poor's 500 up 11.5 percent even with the declines of the last week. More than that, Neeti Bhalla, head of tactical asset allocation at Goldman Sachs private wealth management, pointed out that this was the first year since 2009 in which the S&P did not drop below its starting point for the year, 1,258.

"That was important because at no point this year did people feel a negative return in their equity portfolio," Ms. Bhalla said. "You had pullbacks this year, but you never got to a negative experience."

So what did investors do in a year that was full of uncertainty yet actually quite strong in terms of returns? The opposite of what they should have done: measurements of cash flows showed that investors took money out of equity funds while continuing to put money into fixed income, even though financial advisers were concerned that a slight drop in the price of bonds like Treasuries could quickly result in investors losing money.

"They were looking for stability in the fixed-income markets," said Barbara Reinhard, chief investment strategist for Credit Suisse Private Bank. "The big thing is investors held onto the recent past and couldn't get out of their own way."

Of course, even the professionals would not fault the average investor for being scared by so much uncertainty. Chris Blum, global head of equities at J. P. Morgan Private Bank, said he liked to show clients a series of charts of stock returns over many decades. The trend is up despite periods of declines. But he knows that's not enough to persuade them.

"I can show this kind of data in front of an individual 10 times until Sunday, but the reality is you're not getting in touch with people who are scared," he said. "You need to acknowledge how they feel. You can't say markets are panicking, go buy."

So how should investors have looked at this year? Much of the advice came down to two themes: the world won't end, and politicians will eventually come up with a fiscal agreement. Still, advisers acknowledged that was deeply unsatisfying to clients. (I'd wager it may not have been worth the management fees that investors pay.)

Karen Wimbish, director of retail retirement at Wells Fargo, said she talked to investors about having three sources of income — guaranteed, stable and a pot of money that can grow over time. But she said the simplest solution for contentment in uncertain times was having a set plan.

"You don't need $1 million to sit down and make a plan," Ms. Wimbish said. "Retirement is a long-term proposition. If I'm in it for the long term and I'm saving, some years it is going to be up, some years it is going to be down. But over time, I'm going to be fine."

Mr. Blum said he used data to try to get clients to the same place: while the year may have been bumpy, it was just one year among many.

"I comb the data on a chart to take them through what they're feeling," he said. "I ask them what concerns you about the fiscal cliff or what keeps you from deploying capital. I related those issues to what happens in risk assets and how those concerns get factored into the prices. But it's not a slam dunk."

Mr. Fisher said he tried to show clients that markets generally do a good job of factoring in risk.

"The return we expect to earn on stocks is higher when the risk we perceive is higher and lower when the risk we perceive is lower," he said. "This is simple, but investors always seem to do the wrong thing."

As examples, he said, Europe's economic problems seemed unsolvable in the first and second quarters, and there was speculation that Greece would leave the euro. Large companies in Europe were paying significantly more to borrow money than their counterparts in the United States. **Mr. Fisher** said this was a great investing opportunity that many people missed because of their concern over political and macroeconomic matters.

"The cost of capital for two similar businesses in developed countries shouldn't be too different over time," he said. "There are going to be periods of time when one country is different from another, but over time they converge. Returns on big company stocks have been almost identical over the past 40 years."

Ms. Bhalla said that one of the big problems was just how strong the pull of the recent past is on investors. And since the past five years have not been great, investors may be caught in a feedback loop of fear.

"We think the last five years should not be extrapolated into the next five years," she said. "You want to think where is change happening and is that risk asset accurately priced."

She said investors needed to move away from worrying about whether they will get their money back and start thinking about whether they will make money.

"This year has been one of the most critical in shaking up beliefs about asset pricing," she said. "The most important difference from 2012 to 2010 and 2011 is that expectations have been set lower. People have been surprised by the upside."

She added, "What we find is people are a little more open now to discussing the balance of risk."

This may seem difficult to believe given the stalled negotiations on the fiscal cliff. But while the lack of an agreement may be bad for markets in the short term, the only certainty for next year is something will happen that no one planned for.

"This illusion that everything is O.K. is always an illusion," **Mr. Fisher** said. "Life is full of uncertainty."

Shlomo Benartzi, a business professor at the University of California, Los Angeles, and the chief behavioral economist at Allianz Global Investors' Center for Behavioral Finance, said that investors' confidence had been shaken by volatility in the markets and so much uncertainty around policy decisions.

"I don't think we've had so many times when markets are so volatile and everything is going up," he said. "It would be interesting to ask people what percentage think the market went up this year versus down. I think a lot of people would think the market went down because they confuse the volatility and the bad news."

John Verfurth, a partner at VWG Wealth Management, a division of HighTower Advisers, said investors had spent the past year "completely frozen because of the uncertainty." But he has been trying to talk to his clients about the positive effects of uncertainty. If the country goes over the fiscal cliff and the equity markets go down, the firm will buy more stocks for clients at lower prices.

Still, getting his clients to let go of their fears is more difficult.

"No one believes we're at the beginning of the next 10- to 15-year cycle," he said. "We're trying to be balanced. We're trying to take steps."

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