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Small Investors Flee Stocks, Changing Market Dynamics

By E.S. BROWNING

Many individual investors were tiptoeing back into stocks in the spring. Now, they're running for cover again.

Karen and Roger Potyk, a comfortably retired couple in San Antonio, Tex., had clung to some stock mutual funds despite their anxiety following the financial crisis of 2008. But the renewed market volatility following the "flash crash" of May 6 proved too much to bear.

Karen and Roger Potyk.

Karen and Roger Potyk sold the last of their stock mutual funds after May's market volatility.

"We just didn't want to put up with it any more," says Karen Potyk. She and her husband sold the last of their stock holdings on May 20, moving the money to bonds, certificates of deposit and bond-like annuities.

Small investors' faith in stocks, which surged in the 1990s, has collapsed since the technology-stock debacle and the Enron and WorldCom scandals of 2000-2002. The 2007-2009 financial crisis only made things worse. Now, the pullback among ordinary investors means they are a declining force in a market that is increasingly dominated by professionals.

Some were tantalized by equities during the 70% rally that began in March 2009 and ran through April. But mutual-fund data and other clues suggest that that brief infatuation has ended.

In 2002, investors withdrew more money from mutual funds that invest in U.S. stocks than they put in. Then from 2007 through 2009 they withdrew money for three consecutive years. That marked the first three-year period of withdrawals since 1979-1981, according to the Investment Company Institute, a mutual-fund trade

group. This year, U.S.-stock funds saw inflows in January, March and April, but net withdrawals resumed in May.

Investors talk of a growing disillusionment with big institutions, including corporations, government, banks and political parties—as well as fears about the nation's heavy debt. Some people's confidence in stocks was seriously shaken by the volatility that returned in May. They worry that the May 6 flash crash, when the Dow Jones Industrial Average fell 700 points in eight minutes before rebounding, is a sign that ordinary people are increasingly at the mercy of anonymous companies that trade with powerful computers.

Individual investors were important market pillars in the 1990s, but their flight from stocks is changing the market dynamic. By adding money to mutual funds, individuals helped push stocks higher in the 1990s and to a lesser extent from 2003 through 2006. Now they are moving money out again on balance, making them a drag on the market.

Ordinary investors are returning to the cautious mentality they developed during the 1970s. That was the last extended period of stock weakness, after which it took many people a decade or more to get comfortable with stocks again.

"I feel like the tail of the dog that is being wagged by institutional investors who are taking a lot of risk, playing a lot of games and just have these computerized orders that affect me a lot," says Simeon Thibeaux, a semi-retired businessman from Alexandria, La.

History suggests that individuals eventually will return to stocks, as they did in the 1980s and, even more strongly, in the 1990s. But rebuilding their confidence could take time, says Brian Reid, chief economist of the Investment Company Institute. Historically, it has taken an extended period of stock success to lure individuals back after long periods of disaffection.

Rebounding after a two-month slump, the Dow Jones Industrial Average jumped 511 points, or 5%, to 10198.03 last week, its biggest weekly gain in almost a year, although it remains down 9% since topping out on April 26.

"We have gone through two of the worst bear markets since the Great Depression, and it has given investors a better sense of the risks and dangers of investing" in stocks, Mr. Reid says, referring to the bear markets of 2000-2002 and 2007-2009.

The gradual dissipation of investor confidence can be seen in mutual-fund investing patterns.

After getting hurt in the 2000 tech-stock crunch, individuals came back to U.S.-stock funds in 2003, as stocks were entering a new bull market, ICI data show. But the buying proved tepid and turned to net selling in the latter part of 2006, even before the bull market ended in 2007. Despite occasional periods of inflows to U.S.-stock funds, the selling trend has continued since then. Individuals removed a net $7 billion from stock funds in the seven days ending May 12 and $13 billion two weeks later, eclipsing the deposits from earlier in the year.

Recent volatility has certainly shaken the Potyks' confidence. Mr. Potyk, a 68-year-old pharmacist, spent 25 years as an army officer and 11 years with Pfizer before retiring. His wife, 63, is a retired real-estate broker.

The Potyks stuck with their stocks through the tech wreck, the Sept. 11 attacks and Enron. They were willing to take risks to get stock-market returns. By 2006, he and his financial adviser say, the Potyks' portfolio was 50% stocks and 50% bonds and other fixed-income investments.

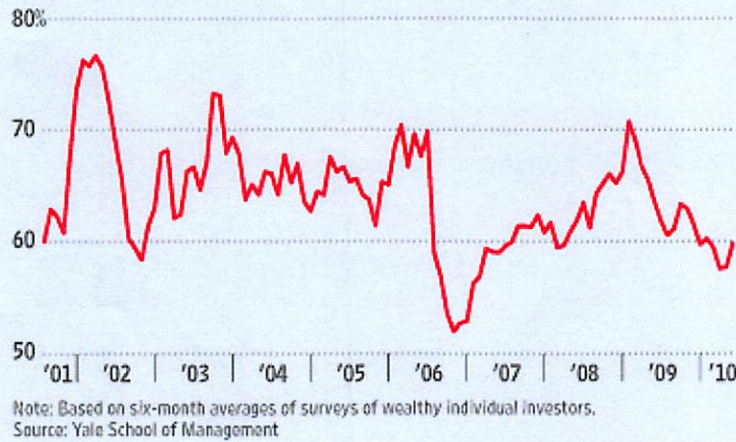
The big blow to their confidence was the 2008 collapse of brokerage-firm Lehman Brothers, in which they lost $75,000 on a Lehman bond. Although it was a bond that hurt them, the Potyks' faith in all potentially risky investments was shattered.

"In the military, you learn that you want people you can respect, trust—who have integrity," Mr. Potyk says. "Over the last five years or so, I find that our financial institutions have no shred of the character I describe."

The last straw was the May market volatility, accompanied by widespread fears about European government debt. On May 20, the Potyks asked their financial adviser to sell the last of their stock mutual funds.

Now that their portfolio consists entirely of fixed-income investments, "I won't make 8% on my money. I will make 4% or 5%, but the money will be there," says Mr. Potyk.

Stocks had developed an almost cult-like following in the 1980s and 1990s, when they were among the best investments available. But in the past decade, big U.S. stocks have had the worst performance of nine major investment classes tracked by investment research firm Morningstar.



The Standard & Poor's 500 stock index has fallen at an annualized rate of 3% a year over the past 10 years, including dividends and controlling for inflation. Long-term Treasury bonds show a gain of 5% a year during that same period, after inflation. Gold is up 10% a year and real-estate investment trusts 8% a year. The S&P 500 index itself, without adjusting for inflation and dividends, is stuck today at a level it first reached 12 years ago, meaning it has gone nowhere in more than a decade, scaring a legion of people in the process.

Reflecting their flight from risk, individual investors appear to be losing faith in an investment strategy called buying on the dips. In times of stock strength, people learn to buy stocks after a decline, when they are cheaper, because the stocks have a tendency to recover. Lately, investors have been reversing that behavior, selling on dips for fear the declines will continue.

The Yale School of Management maintains an index, designed by Professor Robert Shiller, that tracks individuals' willingness to buy on dips, based on a monthly survey of wealthy investors. The index topped out in 2002. While it has moved up and down since then, it has been falling since the start of 2009.

Some investors, haunted by the continuing credit crunch and unemployment fears, are being driven to pull money out of stock funds to make up budget shortfalls.

Also eating away at risk tolerance is demographics: Baby boomers are aging, making them think more about preserving their holdings' value. This is only part of the story, however: The Investment Company Institute data show lower risk tolerance among younger people, too.

In surveys of mutual-fund owners, the ICI found that just 30% said in 2009 that they were willing to take above-average or substantial risk in the stock market, down from 37% in 2008. The number willing to take only below-average risk or no risk at all rose to 20% from 14%.

Mr. Thibeaux of Alexandria, La., sold one-third of his stock mutual funds late in April at the suggestion of an investment adviser, who warned him that stocks were due for a pullback.

The problem was where to put the cash. A money-market fund at his mutual-fund company or a short-term certificate of deposit at his bank would yield almost nothing, he says. He finally decided simply to pay off the mortgage on a second home, on which he was paying 5% interest.

"I think there is no investment strategy now except to buckle up and hope that you don't get hit too hard," Mr. Thibeaux says.

Long-term investors have been showing a distinct change in behavior since 2008. Jay Pestrichelli, who monitors client behavior at online brokerage firm TD Ameritrade, has noted a change in the traditional buy and hold strategy. "People who once made few changes to their accounts have begun trading more frequently," he says. He saw the trend especially clearly on May 6, when there was an uptick of selling.

"A higher percentage of our trading was coming from our longer-term investor base," he says. People who might log into their accounts regularly, but not necessarily trade, were selling heavily that day, he says.

"The next day, those clients were all buying back in," he says, often losing money on a trade where they had sold low and bought higher. "To see that kind of a move in such a short period of time, it certainly can shake their trust."

James Rotenstreich, a businessman in Birmingham, Ala., says the May flash crash damaged his confidence in stocks as a store of wealth.

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"I was just dumbfounded. The whole thing could have melted down, and I wouldn't have had much to do with it one way or the other," he says.

Mr. Rotenstreich has received offers for some real estate he owns in the Birmingham area, but so far has been reluctant to sell, he says, in part because he doesn't know what he would do with the money. He notes that corporate bonds and other alternatives also suffered severely in the market decline.

Reflecting on his options, he says that if he sold the real estate, "I really think I would put it in the bond market. So maybe I have lost some faith in the future of the stock market."

Some investment advisers are telling clients that, for long-term investors, this summer will turn out to have been a great time to buy stocks on the cheap. So far, not many clients are listening.

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