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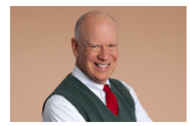

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STOCKS & BONDS

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How to Learn to Love Stocks Again

We show you how to get back into the market without heartbreak.

By **Anne Kates Smith**, From *Kiplinger's Personal Finance*, April 2013

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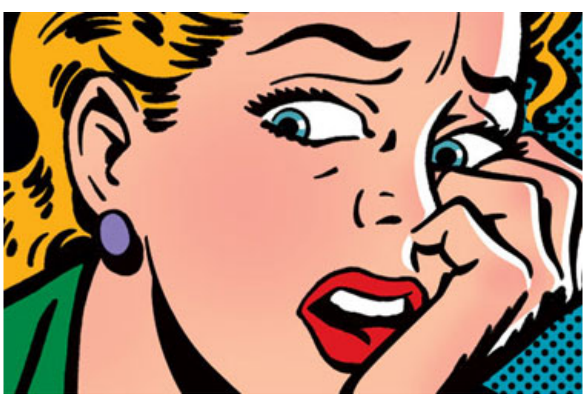

Lou Brooks

After breaking up with the stock market five years ago, Americans are taking some tentative steps toward reconciliation. Like a lot of troubled relationships, this one has been marked by accusations, recriminations, resentment — and a lot of fighting over assets. What stocks did to investors in the bear market of 2007–09 isn't easily healed — across-the-board losses of 50% and more are hard to forget and even harder to forgive. But at the start of 2013, it looked as though investors were ready to renew their vows.

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Lou Horvath, a retail manager in Pembroke, Mass., is among those willing to give stocks another go. Horvath, 44, invested aggressively in stocks until the financial crisis cut his portfolio in half. "I pulled out and stayed out for three years," he says. But last fall, Horvath met Jeff Cutter, an adviser in Falmouth, Mass., who made him feel better about getting back into the market by

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recommending funds that aim to reduce volatility and risk by adjusting their exposure to stocks as their managers see fit. "I'd like to see how this goes, then reevaluate," says Horvath, who still has half of his assets in bonds and certificates of deposit.

Investors who can figure out how to forge a lasting relationship with stocks are likely to be rewarded in the long run. What's surprising is that people only now seem to be coming around to the notion. After all, from the bear market's bottom in March 2009 through February 1, Standard & Poor's 500-stock index returned a sturdy 143% (or 26% annualized). And yet for most of the upswing many individual investors ignored the bull market. Others mistrusted it. And some didn't even realize it existed. Despite a 16% gain logged last year alone, nearly half of Americans surveyed in December by the Edward Jones brokerage firm thought that the market was down or flat in 2012.

Confidence returns

Now, though, propelled by small progress on the nation's fiscal challenges and mostly encouraging economic signs here and abroad, the market has surged 12% from mid November through February 1. That pushed the S&P 500 to just 3% below its record high of 1565, set in October 2007, and caught people's attention.

Since the start of the year, investors have been pouring money into stock mutual funds. In January, stock funds took in $41 billion more than they lost, according to Strategic Insight, a fund-research firm. The figure represents the first positive monthly net inflows since April 2011.

Money Poll

Do you plan on investing more in stocks in 2013?

- Yes.
- No.
- Not sure.

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Optimism is high. According to a recent survey by the American Association of Individual Investors, 48% of those polled said they were bullish on the stock market. That's well above the long-term average of 39%.

It remains to be seen, however, whether the wave of investors returning to stocks will become a groundswell. The start of the year is seasonally strong for mutual funds as investors seed retirement accounts, and $41 billion doesn't go nearly far enough to erase the $548 billion that

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S&P 500	1,614	+16.8
NASDAQ	3,379	+38.0

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CARD TYPE	TODAY	CHANGE	LAST WEEK
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Low Interest	11.01%	—	11.01%
Cash Back	16.38%	▼	16.39%
Rewards	15.89%	▲	15.86%
Business	13.50%	▲	13.17%
Student	16.27%	—	16.27%

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came out of stock funds between 2008 and 2012. Moreover, the next economic calamity, here or abroad, could send investors running for the exits again.

Plenty of people, the recent rally notwithstanding, are still scared stockless. Matthew Hammer is emblematic of a generation smacked so badly at the start of their investing careers that they want nothing to do with stocks. For Hammer, 30, a post-doctoral computer science researcher at the University of Maryland in College Park, it's not just the stock market crash but also the attendant financial scandals that have colored his outlook. Says Hammer: "My cynicism goes deep. I think the financial industry is one big pyramid scheme — or a series of related pyramid schemes. It's like a carnival where all the games are rigged. You're just going to get swindled if you try to participate." Hammer's money now goes into a checking account at his bank.

Older hands have lost faith, too. Ed Harrop, 64, recently retired from Johnson & Johnson, is nostalgic for the days when investors had time to ponder portfolio decisions. "What drives investment decisions now is overwhelming to me, with the vast amounts of data you need to process and the speed with which computer trading and news announcements seem to move the market." Harrop, who has half of his investment assets in J&J stock, had intended to invest more actively upon retirement. "Now, it doesn't seem like fun," he says. "I'd be standing there with a whole bunch of VHS tapes in a CD world." Make that a digital world, where computer algorithms can storm the market in nanoseconds.

Rekindling an old flame

Holdouts like Harrop and Hammer will be hard to lure back into a market that can be mercurial, mysterious and sometimes flat-out badly behaved. Even so, there are good reasons for almost every investor to learn to love — or at least live with — stocks again.

One of the chief arguments for owning stocks is that your portfolio simply cannot be diversified without them. "By definition," says Ben Birken, a financial planner with Woodward Financial Advisors, in Chapel Hill, N.C., "a portfolio without stocks isn't well diversified. That would be like having only 500 out of 1,000 pieces and claiming that you still had a puzzle."

That's not to say that a diversified portfolio, which holds an array of assets, doesn't take its knocks in the market. When nearly all stock market sectors and most asset classes (except Treasury bonds) collapsed in 2008, many market watchers questioned whether diversification was still a relevant strategy. But over time, a diversified portfolio provides the best combination of reasonable returns with bearable volatility. Researchers at fund company T. Rowe Price compared the returns of portfolios that varied from 100% in bonds to 100% in stocks with various combinations of stocks, bonds and cash in between those extremes. From 1985 through 2012, a portfolio of 60% stocks, 30% bonds and 10% cash would have returned 9.8% annualized — about 93% of the return of an all-stock portfolio, but with just 62% of the risk.

Many investors' portfolios today are lopsided in favor of bonds. The flight to safety was a good call during the bear market in stocks; but today, the risks in bonds are greater, and the values in stocks are better. For now, bondholders can expect to earn whatever they collect in interest, with little or no price appreciation — which means returns in the low single digits. That compares with a likelihood of high single digits — and possibly more — from stocks. For income investors, dividend-paying stocks are an enticing alternative to bonds, with the 2.2% average yield on S&P 500 stocks eclipsing the 2.0% yield on ten-year Treasuries, and with many high-quality companies offering dividend yields well above the yields of their bonds.

Because interest rates have been on the down escalator for more than three decades, investors may be unprepared for the risk of higher rates (bond prices move in the opposite direction of interest rates). Bond market yields won't rise right away; the Federal Reserve has committed to keeping short-term interest rates, which it controls, low until the unemployment rate falls further, and it is trying to keep market rates down through its massive bond-buying program. But bond investors almost certainly will anticipate rate hikes before the Fed starts tightening. A rise in yield of less than a half-percentage point would reduce the return of a ten-year Treasury to zero over the course of a year.

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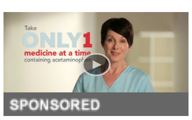

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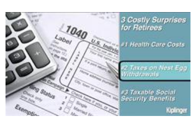
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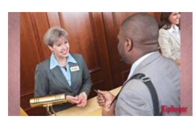
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