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Investors need nerves of steel for markets

Kathleen Pender
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The past two weeks have reminded us that the markets are not a good place for the nervous or naive.

First we saw Goldman Sachs getting grilled by Congress for allegedly lying to clients and profiting from their losses in mind-bending securities.

Next came American Investor Idol Warren Buffett, who once called derivatives "weapons of mass destruction," defending Goldman - a major derivatives arms dealer - and asking Congress to exempt his own company's multibillion-dollar derivatives portfolio from potential regulation.

Then on Thursday, turmoil in Greece and a possible glitch aggravated by robot trading sent the Dow down almost 1,000 points before it snapped back.

Is this any place for an individual investor?

That's the question many advisers are getting from clients.

"People are numb," says Bob Goldman, a financial planner in Sausalito. "They were just crawling out from under their beds. The market was going like gangbusters. Then we had Goldman, then Greece, then this," he said, referring to Thursday's plunge.

"These blows seem to be less about fundamental economic issues and more about corruption and fast trading," he says. "The real question people are asking is, 'Is this anyplace I can be? Is there anything happening here I can relate to my own life?' "

Here's how some advisers are answering that question.

'We need the eggs'

Goldman says he tells clients "to look at your own situation. If you need to make 6 percent long term, you have to be in the stock market. There is no place else to get it. But the game is not to make as much money as you can. It's to take as little risk as you can to achieve your goals. Or change your goals."

Clients come to him with "all sorts of aggressive investments they don't need or understand," he says, such as a 65-year-old woman with a portfolio of tech stocks or people who have been sold 30 different mutual funds and think they are diversified. "They're not. Eighty percent of what they have could be achieved in an S&P 500 index fund and the rest in an international index fund," he says.

Gradual investing

Goldman has been advising clients to keep anything they might need in two to five years in cash and gradually invest the rest in something like a Vanguard target retirement fund.

He recalls the scene at the end of "Annie Hall" where Woody Allen's character, Alvy Singer, tells the old joke about the guy who goes to a psychiatrist and says, "Doc, my brother's crazy, he thinks he's a chicken." The doctor says, "Well, why don't you turn him in?" And the guy says, "I would, but I need the eggs."

Alvy was explaining why people continue to pursue absurd, irrational relationships but it also explains why people stay in the market. "It's crazy. It's probably corrupt, but some of us need the eggs," Goldman says.

Howard Simons, a strategist with Bianco Research near Chicago, says the stock market "remains a dangerous place" for individuals.

Tempted by risk

"All markets are distorted because we have driven short-term interest rates artificially low. We have created huge instabilities. We have punished people for taking no risk," he says.

People are tempted to take risk because they are sick of earning almost nothing on safe assets. But, he says, "to take more risk means you have to start accepting a high probability of negative returns. You don't get a free lunch in this world. Over the last 20-plus years, you have actually had inversions between risk and return.

"You have not gotten paid for taking more risk the way the finance textbooks said you would. Treasury bills have outperformed stocks since the late 1990s." This will persist "until we stop creating free money."

It may sound counterintuitive, but the time to take risk, he says, is when short-term interest rates are high because when they come down, the economy grows, profit margins increase, and stocks do well.

There are lots of reasons to buy stocks, he says. "The fact that you are not earning money in a money market fund is not one of them."

Kurt Brouwer, chairman of Brouwer and Janachowski, was not surprised by the market's recent gyrations. "We told people in our last commentary a correction was coming. A run-up in the equity market like we saw last year and much of this year can't go on forever." Stocks were "overbought," and the Greek debt crisis was just "a trigger."

'Anything, everything'

Nor was he surprised by the goings-on at Goldman Sachs. "This is not new. Some elements of Wall Street will do anything and everything they can (to make money), even at the risk of potentially harming their clients and the economy," he says.

"There is also widespread distrust of government at every level." The financial services reform bill "will not reform anything. It's a permanent bailout bill, and people realize that, too," Brouwer says.

Even so, the market is a place for individuals. "It has gone through the Great Depression, World War I, World War II, the Cold War," he says. "It's a way to make money."

But "diversification is important. We use no-load mutual funds and exchange-traded funds," Brouwer says.

"To be a good investor, you have to avoid the emotional peaks and valleys. If you are able to make a leap of faith (and buy now), you are getting better prices and valuations than you would" when things seem safer.

Fair, but not safe

When the market has a day like Thursday, Ed Osborn, a principal with Bingham, Osborn & Scarborough in San Francisco, tells clients "to look at what they own. Our average client is 50 percent in stocks. If the market is down 3 percent, they are down maybe 1.5 percent for the day. Almost always the reality will soothe them."

He also reminds them that in any 12-month stretch, it is not unusual for stocks to drop 10 to 15 percent. Since April 23, the Standard & Poor's 500 is down 8.7 percent, wiping out this year's gains. But it is still 22 percent higher than it was a year ago.

Osborn says the stock market is not a safe place for individuals, but it is the fairest market of all.

"It's the one market where individuals can compete successfully with institutions," he says. "All prices are public knowledge. We have competitive bidding and a prohibition against trading based on private nonpublic information."

'Fair value'

Despite Thursday's possible glitch, it still "does the best job of pricing things at fair value," he says.

He is confident that regulators and the exchanges will put controls in place to prevent another event like that.

It's important to draw a distinction between the stock market and the market for mortgage-backed securities and credit default swaps, which were at the heart of the Goldman inquiry.

"The individual has no place in that market," Osborn says. "There is no prohibition against insider trading," and many of the securities are not publicly traded or regulated. "It's just a whole different world."

Net Worth runs Tuesdays, Thursdays and Sundays. E-mail Kathleen Pender at kpender@sfchronicle.com.

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