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In Striking Shift, Small Investors Flee Stock Market

By GRAHAM BOWLEY

Renewed economic uncertainty is testing Americans' generation-long love affair with the stock market.

Investors withdrew a staggering $33.12 billion from domestic stock market mutual funds in the first seven months of this year, according to the Investment Company Institute, the mutual fund industry trade group. Now many are choosing investments they deem safer, like bonds.

If that pace continues, more money will be pulled out of these mutual funds in 2010 than in any year since the 1980s, with the exception of 2008, when the global financial crisis peaked.

Small investors are "losing their appetite for risk," a Credit Suisse analyst, Doug Cliggott, said in a report to investors on Friday.

One of the phenomena of the last several decades has been the rise of the individual investor. As Americans have become more responsible for their own retirement, they have poured money into stocks with such faith that half of the country's households now own shares directly or through mutual funds, which are by far the most popular way Americans invest in stocks. So the turnabout is striking.

So is the timing. After past recessions, ordinary investors have typically regained their enthusiasm for stocks, hoping to profit as the economy recovered. This time, even as corporate earnings have improved, Americans have become more guarded with their investments.

"At this stage in the economic cycle, $10 to $20 billion would normally be flowing into domestic equity funds" rather than the billions that are flowing out, said Brian K. Reid, chief economist of the investment institute. He added, “This is very unusual.”

The notion that stocks tend to be safe and profitable investments over time seems to have been dented in much the same way that a decline in home values and in job stability the last few years has altered Americans’ sense of financial security.

It may take many years before it is clear whether this becomes a long-term shift in psychology. After technology and dot-com shares crashed in the early 2000s, for example, investors were quick to re-enter the stock market. Yet bigger economic calamities like the Great Depression affected people’s attitudes toward money for decades.

For now, though, mixed economic data is presenting a picture of an economy that is recovering feebly from recession.

“For a lot of ordinary people, the economic recovery does not feel real,” said Loren Fox, a senior analyst at Strategic Insight, a New York research and data firm. “People are not going to rush toward the stock market on a sustained basis until they feel more confident of employment growth and the sustainability of the economic recovery.”

One investor who has restructured his portfolio is Gary Olsen, 51, from Dallas. Over the past four years, he has adjusted the proportion of his investments from 65 percent equities and 35 percent bonds so that the $1.1 million he has invested is now evenly balanced.

He had worked as a portfolio liquidity manager for the local Federal Home Loan Bank and retired four years ago.

“Like everyone, I lost” during the recent market declines, he said. “I needed to have a more conservative allocation.”

To be sure, a lot of money is still flowing into the stock market from small investors, pension funds and other big institutional investors. But ordinary investors are reallocating their 401(k) retirement plans, according to Hewitt Associates, a consulting firm that tracks pension plans.

Until two years ago, 70 percent of the money in 401(k) accounts it tracks was invested in stock funds; that proportion fell to 49 percent by the start of 2009 as people rebalanced their portfolios toward bond investments following the financial crisis in the fall of 2008. It is now back at 57 percent, but almost all of that can be attributed to the rising price of stocks in recent years. People are still staying with bonds.

Another force at work is the aging of the baby-boomer generation. As they approach retirement, Americans are shifting some of their investments away from stocks to provide regular guaranteed income for the years when they are no longer working.

And the flight from stocks may also be driven by households that are no longer able to tap into home equity for cash and may simply need the money to pay for ordinary expenses.

On Friday, Fidelity Investments reported that a record number of people took so-called hardship withdrawals from their retirement accounts in the second quarter. These are early withdrawals intended to pay for needs like medical expenses.

According to the Investment Company Institute, which surveys 4,000 households annually, the appetite for stock market risk among American investors of all ages has been declining steadily since it peaked around 2001, and the change is most pronounced in the under-35 age group.

For a few months at the start of this year, things were looking up for stock market investing. Optimistic about growth, investors were again putting their money into stocks. In March and April, when the stock market rose 8 percent, $8.1 billion flowed into domestic stock mutual funds.

But then came a grim reassessment of America's economic prospects as unemployment remained stubbornly high and private sector job growth refused to take off.

Investors' nerves were also frayed by the "flash crash" on May 6, when the Dow Jones industrial index fell 600 points in a matter of minutes. The authorities still do not know why.

Investors pulled $19.1 billion from domestic equity funds in May, the largest outflow since the height of the financial crisis in October 2008.

Over all, investors pulled $151.4 billion out of stock market mutual funds in 2008. But at that time the market was tanking in shocking fashion. The surprise this time around is that Americans are withdrawing money even when share prices are rallying.

The stock market rose 7 percent last month as corporate profits began rebounding, but even that increase was not enough to tempt ordinary investors. Instead, they withdrew $14.67 billion from domestic stock market mutual funds in July, according to the investment institute's estimates, the third straight month of withdrawals.

A big beneficiary has been bond funds, which offer regular fixed interest payments.

As investors pulled billions out of stocks, they plowed $185.31 billion into bond mutual funds in the first seven months of this year, and total bond fund investments for the year are on track to approach the record set in 2009.

Charles Biderman, chief executive of TrimTabs, a funds researcher, said it was no wonder people were putting their money in bonds given the dismal performance of equities over the past decade. The Dow Jones industrial average started the decade around 11,500 but closed on Friday at 10,213. “People have lost a lot of money over the last 10 years in the stock market, while there has been a bull market in bonds,” he said. “In the financial markets, there is one truism: flow follows performance.”

Ross Williams, 59, a community consultant from Grand Rapids, Minn., began to take profits from his stock funds when the market started to recover last year and invested the money in short-term bonds, afraid that stocks would again drop.

“We have a very volatile market, so we should be in bonds in case it goes down again,” he said. “If the market is moving up, I realized we should be taking this money and putting it into something more safe rather than leaving it at risk.”