Weekly Market Commentary

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What the Fed Can't Do

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Highlights

As professional investors generally have maintained an outlook for gains this year, individual investors seem to be plagued by distrust in the financial system and continue to sell stocks.

One of the reasons investors were able to get over the scandals and shocks to the market in prior decades relatively quickly was that investors were focused more on long-term results than they are today.

Investor time horizons have contracted from three to five years* a few decades ago to less than six months today, making short-term market moving events and volatility a bigger negative factor for individual investors.

Last week, there was some encouraging news from the Federal Reserve (Fed) and the European Central Bank (ECB) along with some better U.S. economic reports. But individual investors do not seem to care much. Cash flows remain negative for mutual funds that invest in U.S. stocks despite gains for the year.

Despite the sluggish U.S. economy, European debt problems, and many other risks, the stock market has remained in positive territory this year, as professional investors generally have maintained an outlook for gains this year as the global economy and corporate earnings growth muddle through. In contrast, individual investors seem to be plagued by distrust in the financial system and continue to sell stocks.

It is easy to see why. Setting aside the huge hit to confidence from the failure of Lehman Brothers in 2008 and the Flash Crash of 2010, recent headlines have featured plenty of confidence-shaking scandals. These include the major banks rigging LIBOR (a key benchmark intra-bank lending rate), insider trading by former Goldman Sachs director Raj Gupta, and the disappearance of customer funds from MF Global and PFG Best. Adding to the sense of injustice extending from these scandals are the botched Facebook IPO and stunning trading losses at JPMorgan, and last week, the glitch among the high-speed trading computers at Knight (a market maker that handles 17% of all trading on the NYSE and NASDAQ) that triggered millions of unintended orders sending the prices of some stocks on a wild ride.

Nothing New

To be sure, these issues of fairness and market integrity in the stock market are not a new phenomenon. The 1987 crash was driven by computer trading strategies. The selective information flow that disadvantaged individual investors in the late 1990s and led to Regulation Fair Disclosure (so-called Reg. FD) was followed by the corporate scandals of the early 2000s that included large U.S. companies such as Enron, Adelphia, Worldcom, and Tyco. But these events from decades past did not keep individual investors from returning fairly quickly to buying stocks, based on monthly mutual fund flow data from the Investment Company Institute (ICI).

Investors got over these events relatively quickly perhaps given how strong returns were for stocks in the decade prior to when they occurred. Currently, the combination of lackluster returns for stocks over the past decade and new questions about the integrity of the markets are making would-be stock market investors think twice about taking on the risk of owning stocks.

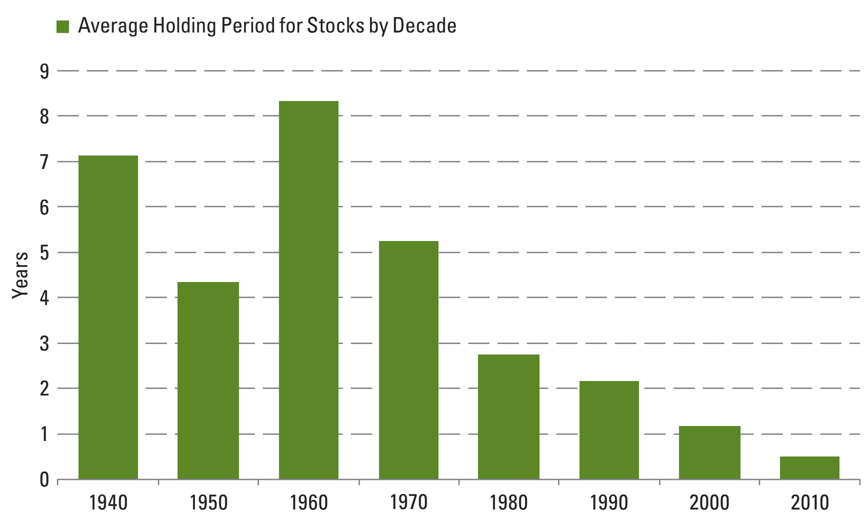
The signs of a falloff in investor confidence are not hard to spot. While statements from the Fed and the ECB can push the market around and shift professional investor sentiment on any given day (as we saw this past Friday, August 3), individual investors remain steadfastly pessimistic as evidenced by continuing outflows and a preference for safe haven assets. Cash flows to U.S. stock mutual funds have been negative most months of the past five years. July 2012 was no exception to this trend. In fact, these funds have not seen a month of net inflows since April 2011. Net inflows have remained very strong for taxable bond funds despite low interest rates and cash balances have remained at high levels.*

Short-Term Focus

While these events are unwelcome, they do not alter earnings growth for U.S. companies, the driver of long-term returns for stocks. One of the reasons stocks were able to move higher on improving fundamentals, such as earnings growth, in prior decades was that investors were focused more on long-term results than they are today.

The time horizon of the average investor's investment perspective has changed dramatically over the years, as you can see in Figure 1. According to data from the New York Stock Exchange, the average holding period for stocks in 1960 was about eight years. By 1970, it had slid to a little over five years. By 1980, it had fallen to just under three years, by 1990 to two years, by 2000 to just one year, and in 2010 it reached a mere six months. In 2012, the ETF that tracks the S&P 500 turns over its full market capitalization in trading volume about once every five days.

1 Investors' Focus Has Become Short-Term



Source: LPL Financial, NYSE 08/06/12

Andy Warhol famously made the statement that in the future, everyone will be famous for 15 minutes. What seems more certain is that in the near future, stocks may be owned by investors for just 15 minutes.

One of the consequences of such a short investment time horizon is that investors have begun to fear short-term market events and volatility as much or more than the factors that shape prospects for long-term economic and profit growth that drive stocks over the longer term.

While the Fed seeks to boost the confidence of investors in the economic environment, the regulator has proven powerless to restore the sense of integrity that many feel is missing from the stock market. The short-term stock market moves based on the outlook for action by the Fed and ECB have done little to boost confidence among individual investors. While stocks may go on to post gains this year, it is likely to be some time before individual investors return to the stock market and drive a meaningful lift in stock market valuations that remain low by historical standards. ■