Bloomberg Businessweek

MARKETS & FINANCE April 29, 2010, 5:00PM EST

Why Small Investors Are Shying from Stocks

The Dow's surge hasn't lured them back, perhaps signifying a lasting behavior change—or a lot of cash about to reenter the market and fuel the rally

By Roben Farzad

Small investors have loved and lost. And lost again. They fell in love with the New Economy, only to see their tech stocks implode. Those who stuck with the market or piled in again had to wait until 2006 just to revisit the old high. Then they got their hearts broken in 2009 when credit markets froze and the Dow Jones industrial average plunged to a level that, in inflation-adjusted terms, was last seen when LBJ was President.

Now the market is beckoning again. Since its low of 6547 on Mar. 9, 2009, the Dow is up 69%—one of the biggest and fastest surges in history. The conditions for renewed romance between stocks and the individual investor seem ideal: Markets are hot, people have money to spend, and competing choices like certificates of deposit and money-market accounts pay next to nothing.

But so far small investors are resisting the market's call. "The individual investor has been twice bitten, 77 times shy," says Tobias Levkovich, Citigroup's chief U.S. equity strategist. "You don't suddenly get euphoria after losing half of your money twice in a decade." Already, finance academics are using the almost Freudian term "equity abandonment" to describe the popular aversion to stocks. Long-term, that stance could mean less money available for retirement, education, and home purchases.

According to the Investment Company Institute, since last year's market bottom investors have pulled $24.6 billion out of mutual funds focusing on U.S. equities; over the same period, they've channeled $455.6 billion into bond funds.

The preference for bond funds is especially striking because with the Federal Reserve keeping rates low to encourage economic growth, yields on almost all low-risk fixed-income investments are negligible. Ten-year Treasury notes yield just 3.77%; three-month bills offer 0.16%. And bank accounts offer close to zero—Bankrate.com's national average rate for a one-year CD clocks in at 0.71%. Factor in taxes and inflation—now running at 2.4% a year—and you're losing money on cash in the bank. Normally, such yields encourage a shift to stocks. "Fed Chairman Ben Bernanke is in fact begging us to speculate," says Jeremy Grantham, chief investment strategist of Boston money-management firm GMO. But many investors are ignoring him.

Bill Schmick, a portfolio manager with Berkshire Money Management, a $250 million shop in Pittsfield, Mass., reports that clients who come in with longer-term 3% and 4% certificates of deposit that are maturing are "shocked at how hard it is to secure just a percentage point" in today's money markets. Yet they remain wedded to an "anything but stocks" mentality. "People have gotten hit real bad and watched their investment houses get bailed out—or worse—and then inter-rogated on Capitol Hill," he says. *"So you gonna listen to your broker?"*

And it's not as if no one has any money. The Fed says households have $7.8 trillion in bank accounts and money funds. That's almost a record high in relation to disposable personal income, according to Wells Capital Management. "Retail investors have massive dry powder and remain woefully underexposed to risk assets," says James W. Paul-sen, the firm's chief investment strategist.

In recent downturns, the discipline of automatic investment through company-sponsored retirement plans has kept individual investors in the market. That, too, can no longer be taken for granted. A study by the Profit Sharing/401k Council found that 15% of the companies it surveyed had suspended their matches in 2008 and 2009, with an additional 4% reducing their matches. While many of these companies say that they plan to restore benefits by midyear, the cost of missing last year's rally is already huge.

Investors who want to get back in now face the quandary of market timing: Buy now and risk a painful pullback after the big move upward; wait too long and the market can keep running away.

Does the small investor's current wariness of stocks signal a lasting change in behavior? Some market watchers worry that a whole generation of equity investors has checked out. Remember, though, that reports of the small investor's demise have turned out to be greatly exaggerated time and again. Eventually, the jaded retail investor will have to pile back in to make up for lost time.

Of course, professionals draw contrarian comfort from small investors' lack of enthusiasm; it means there's plenty of cash to keep the rally going. Wrote Jason Trennert, chief investment strategist at Strategas Research Partners, in a hopeful note to his clients: "We see the paucity of flows into equity funds as some indication that a significant market constituency—the retail investor—has yet to fully embrace the current bull market." After all, Trennert says, the market is merely back to a level first crossed in 1999.

The bottom line: Small investors who have suffered big stock market losses are avoiding the market, possibly to their own detriment.

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