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The Flight from Risk

The financial crisis caused investors to run en masse from anything risky, and many still won't buy stocks. The lesson learned: Don't ignore risk

By Ben Steverman

A year after Lehman Brothers filed for bankruptcy, throwing world financial markets into turmoil, BusinessWeek *examines the landscape for investors and Wall Street. This is the first in a series of stories.*

It's been quite a year for investors, a tumultuous 12 months since the collapse of investment bank Lehman Brothers on Sept. 15, 2008.

Firms like Lehman Brothers lived dangerously and paid the price. So did many individual investors saving for retirement. In turn, investors have turned away from anything remotely risky.

While some experts believe aversion to risk is a temporary response to the financial crisis, others insist it should be a permanent change. The events of the past year demonstrate, they say, that the entire investment industry has been embracing too much risk as it prepares clients for retirement. "We've been underestimating risk," says Stephen Horan, head of professional education content and private wealth at the CFA Institute. The last year, and the last decade, have shown that "bad years" are far more frequent than many believed.

A WILD RIDE

"Our industry has been driving client portfolios at 60 to 80 miles per hour," says Paula Hogan, of Hogan Financial Management in Milwaukee. "But if they took us out to dinner they would drive at 30 to 40 miles per hour."

Those client portfolios crashed along with the market from 2007 to early 2009, with investor panic reaching its height after the Lehman collapse a year ago. The Standard & Poor's 500-stock index, the broad U.S. stock index, dropped 9% in September 2008 and another 17% in October 2008 as investors worried the world's financial system would stop operating. Casualties of the crisis included not just Lehman but mortgage giants Fannie Mae (FNM) and Freddie Mac (FRE), insurer American International Group (AIG), and banks Merrill Lynch, Washington Mutual, and Wachovia—all forced to either accept government takeovers or be acquired by competitors at extremely low prices.

After those events, "people understand that worst-case scenarios can be far worse than they ever imagined," says Michael Yoshikami, president and chief investment strategist at YCMNET Advisors. By March 2009, the S&P 500 had lost 57% from the October 2007 peak. A subsequent rebound—a 50% advance from March to September 2009—has eased some nerves. But the S&P 500 would still need to gain another 50% to return to its all-time high.

During the most recent crisis, or any market turbulence, investors' natural psychological reaction often makes their situation worse, says professor Vickie Bajtelsmit, chair of the finance and real estate department at Colorado State University. Panicking over their losses, individual investors often sell at the bottom of the market,

and then don't buy in again until investments are well on their way to recovery. They essentially lock in losses and miss out on gains, she says.

It's no wonder that many individual investors are still skittish, after the past year's steep losses not just in equities but in corporate bonds, real estate—almost every asset class except cash and government bonds. The appropriate level of equity exposure has become a particular flash point, intensifying a debate about risk among investment experts and pitting financial advisers against clients and even spouse against spouse.

CASHING OUT OF EQUITIES

Now that stocks have recovered some losses, advisers say many clients are seizing the opportunity to cash out of equities and invest more cautiously in the future. Clients come to financial planners like Frank Boucher, based in Reston, Va., saying they want no exposure to the stock market at all. Boucher warns them that, without the chance for equity gains, they might need to work longer, save more, or spend less. "They say, 'That's fine. At least I get to sleep at night,' " Boucher says.

These risk-averse investors are often on the right track, some advisers and academics say. The investment industry has been too cavalier about the dangers of investing, too willing to emphasize the benefits of risk and ignore the potential pitfalls. "Financial planners are experiencing a tremendous backlash from their clients," says Zvi Bodie, a professor of management at Boston University and a leading advocate of a more conservative investing industry. "People are being put at risk without being told how much they're at risk," he says.

Conventional wisdom says that as long as a portfolio is well-constructed and diversified, a riskier investing strategy will tend to outperform a more conservative one. An ingredient in almost every portfolio, then, is equities—even well into retirement. Volatile and unpredictable, stocks may be the wrong place for money you need in five years, but it is the right place for retirement money you won't touch for 20 or 25 years, experts say.

Investing guidelines like these have pushed even cautious individuals into the stock market. Women, studies show, are far more risk-averse than men, but in the last 10 years they began to boost their equity exposure significantly, says Colorado State's Bajtelsmit, who has studied women's investing styles. "They did start to be convinced," Bajtelsmit says. "Now, they got burned."

TIPS WINNING FANS

Bodie contends that equities are just too risky for most individuals. Over the long term, stocks might tend to outperform other kinds of investments. But, depending on when you start investing and when you retire, stocks can be disastrous. While wealthy investors might be O.K., most individuals can't afford to absorb the big losses that can hit the stock market from time to time. "There's a notion that somehow if you have a long time horizon you're going to outperform everything with stocks," Bodie says. "If that were true, stocks wouldn't be risky."

Moreover, Bodie argues, stocks are sold as a hedge against inflation when there is no proof to this idea. Yes, over the very long term, equities have kept pace with inflation—just as they have outperformed other investment classes. But in periods of high inflation, stocks have done poorly, as in the 1970s.

As Hogan, who has co-written articles with Bodie, puts it: "There is a belief in our industry that stock investing will get you where you want to go. And it might. But it might not."

Bodie advocates investing in Treasury Inflation Protected Securities, or TIPS, federal government bonds that guarantee to cover inflation. As long as they are well-priced, he also favors annuities, which provide investors with a guaranteed income stream in retirement.

Bodie's ideas are gaining influence among investors and their financial advisers, Horan says. Others who help individuals plan for retirement are adopting risk-management approaches used by pension funds. If a pension fund is worried about having enough cash, it must invest conservatively. But "if you have a surplus, you can take more risk," explains Horan.

RETURN TO CONSERVATIVE INVESTING

While conservative investing styles have gained attention in the past year, it remains to be seen whether the flight from risk is permanent or temporary. Financial adviser Marnie Aznar says clients now recognize the importance of a large emergency fund invested in the safest way possible. Dead and gone, she says, is the idea that "this boom in the stock market is going to take care of everything for me."

However, Aznar, who advises mostly younger, high-income clients in Morris Plains, N.J., says equities should be a part of average Americans' portfolios. Most Americans aren't saving enough to retire any other way, she says. "Unfortunately, the savings rate is incredibly low," she says. To achieve retirement goals, "you need a combination of saving more and a higher rate of return [from stocks]."

Financial advisers say the proper level of risk in a portfolio is often a very personal and individual decision. If a client enjoys skydiving in his spare time, "inherently that person's risk tolerance may be higher than other people's," says Avani Ramnani, an adviser at Eisner Retirement Solutions. But Ramnani, who has always pursued a more conservative strategy, often warns clients against taking more risk than they can afford.

If Americans remain skeptical of equities and other risky strategies, they may need new investment products better suited to a risk-averse style. For example, advisers complain of the high fees and complicated structure of many annuities. Bodie would like to see the federal government sell longer-term TIPS.

But for many, a return to conservative investing is not a new approach. "I've always subscribed to the idea that you build wealth by controlling your expenses and debt, and not by trying to jump for investment returns," Boucher says.

Fleeing from risk might be the natural response to the collapse of Lehman Brothers and the bailout of many financial companies. But it also returns investors to some old-fashioned advice that has stood the test of time.

Steverman is a reporter for BusinessWeek's Investing channel.