SPECIAL REPORT

A FAR FROM RANDOM WALK FROM WALL STREET

Burned by the crash, U.S. retail investors are fleeing the stock market. Will the Lost Decade create a Lost Generation?

REUTERS/BRIAN SNYDER

BY LEAH SCHNURR AND EDWARD KRUDY
NEW YORK, NOV 19

Leanne Chase took her money out of stocks in early June 2008 before the collapse of Lehman Brothers sparked a near-panic. She said she and her husband had the same feeling they had during the dot-com bubble: The market had become just "weird."

Though the couple had been in and out of the market before, Chase, a 42-year-old part-time consultant and self-described conservative investor, said she has no intention of getting back in again.

"It makes me nuts when I get out early and there's more money to be made, or I get out late when I could have made more if I'd gotten out early," she said. "The stock market's not an investment, it's gambling."

"THE STOCK MARKET'S NOT AN INVESTMENT, IT'S GAMBLING."

REUTERS

The faith -- and money -- individual investors once held in the stock market has severely eroded. Two painful major stock market crashes over the last decade combined with the advent of arcane, complicated trading practices has created widespread suspicion of Wall Street, which many people now regard as no better than a roulette table.

The last crash wiped out all of the gains made during the 2000s after the dot-com wipeout. The worry now is that a Lost Decade will create a Lost Generation of investors who avoid the market in a way not seen since the Great Depression.

If that happens, smaller investors could end up safe -- and sorry. Experts fear people will be unprepared for retirement as a result of their exit from equities. By shunning stocks they may also be helping to create precisely the kind of stock market that ordinary investors rightly detest: one driven by day traders with low volume and prone to sudden reversals in direction.

What's clear is that whatever love affair many Americans may have had with stocks is over, at least for the moment.

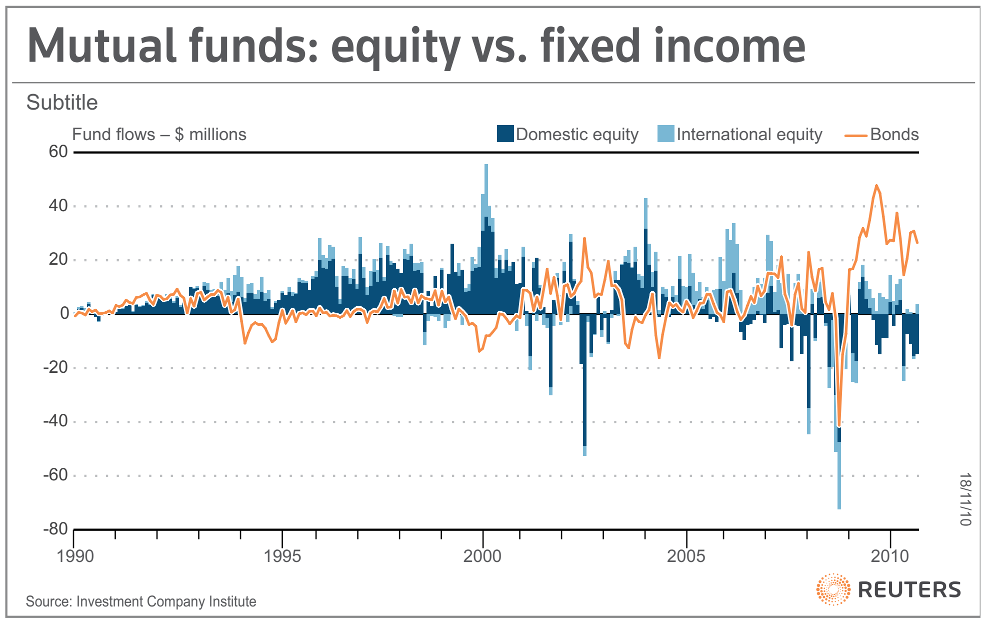
By the end of 2008, $234 billion fled equity mutual funds as the stock market spiraled, according to data from the Investment Company Institute (ICI). The last quarter of 2008 was characterized by late-day market drops as a run of client redemptions forced mutual funds to sell their holdings in order to raise cash.

Last year, investors continued to leave even as the market stabilized. At the time, the worst seemed over, with just $9 billion coming out of equities overall and money starting to flow back into international stock funds again.

But losses intensified again in 2010. ICI estimates $19 billion has left mutual funds for the year so far as of the end of August. In September, equity funds recorded their fifth consecutive month of outflows. That sort of thing tends to happen only after a major event: there was a seven-month run of outflows in 2008, smack in the middle of the financial crisis, and an eight-month streak starting October 1987 after Black Monday. This time around, the flash crash may be to blame.

For the most part, investors are eschewing stocks for the perceived safety of bonds and other fixed income assets, trading the possibility of high returns for stability. Bond funds took in an unprecedented $376 billion in 2009 and another estimated $216 billion

HOME INVESTING: Leanne Chase poses for a portrait with a chart of the Dow Jones Stock Market on her laptop computer screen at her home in Boston, Massachusetts, November 18, 2010. **REUTERS/BRIAN SNYDER**



Reuters graphic/Stephen Culp

in 2010 as of the end of August.

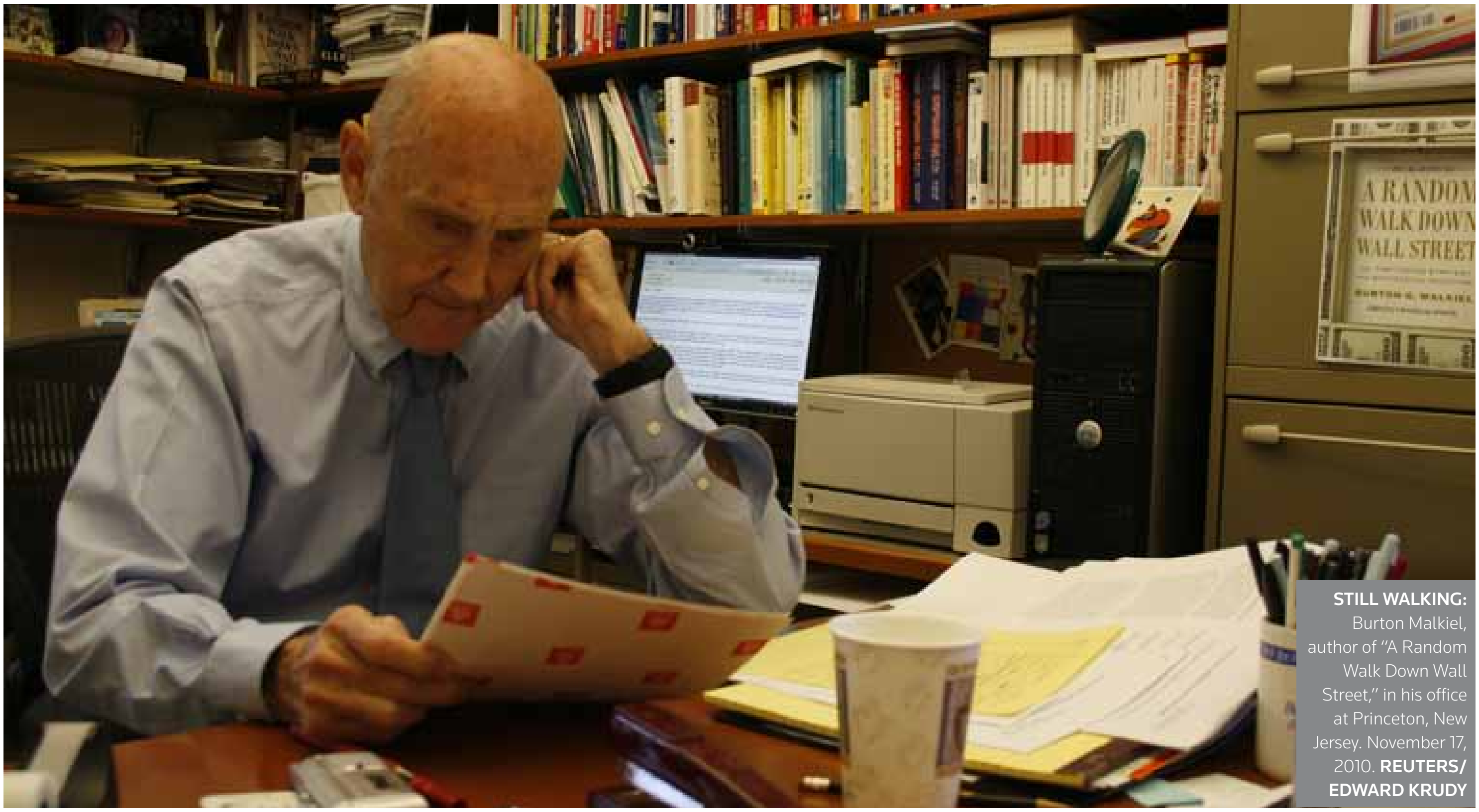
WALK ON BY

ALTHOUGH 90 PERCENT of the stock market is owned by 20 percent of the top income earners, according to Citigroup, the perception of public capital markets as the place where capitalism became a democracy has been a cornerstone of America's promise.

Now, as in the wake of the Great Depression, a generation of investors may have become alienated from the stock market.

Sol Malkiel, a costume jewelry wholesaler from Boston, lost what little money he had in the crash of 1929, an experience that was to instill in him a life-long aversion to stocks. Nearly half a century later his son, an economist at Princeton, would publish a book that would rank him as one of the great 20th-century proponents of stock market investing and make him an intellectual light to a generation of America's small investors.

If every bull market has its intellectual doyens, Burton Malkiel -- author of the 1973 book, "A Random Walk Down Wall Street" -- was certainly one of them during the stock market's dizzying run over nearly two decades starting in 1982. The book, due for its 10th edition later this year, has sold over 1.5 million copies, according to its publisher.



STILL WALKING: Burton Malkiel, author of "A Random Walk Down Wall Street," in his office at Princeton, New Jersey. November 17, 2010. **REUTERS/ EDWARD KRUDY**

"MY FATHER DIDN'T HAVE MUCH MONEY, BUT HE LOST WHATEVER HE HAD IN THE CRASH AND NEVER WANTED TO BE IN THE STOCK MARKET AGAIN."

An ironic and sometimes caustic look at the often weird and occasionally wonderful world of Wall Street, "A Random Walk" held that an individual investor could beat the pros over the long run by simply picking a broad-based stock market index.

Malkiel, sitting in his office in Princeton, is convinced that abandoning the market in times of uncertainty is exactly the opposite of what investors should do. He is worried by the possibility that a swath of people will never buy stocks again, much like his father after the crash of 1929.

"My father didn't have much money, but he lost whatever he had in the crash and never wanted to be in the stock market again. It was a terrible mistake and anyone who bought any stocks in the 1930s and 1940s did extremely well," said Malkiel. "We might very well have created another generation of people who don't want to touch it. It was wrong in the '30s and I think it's wrong today."

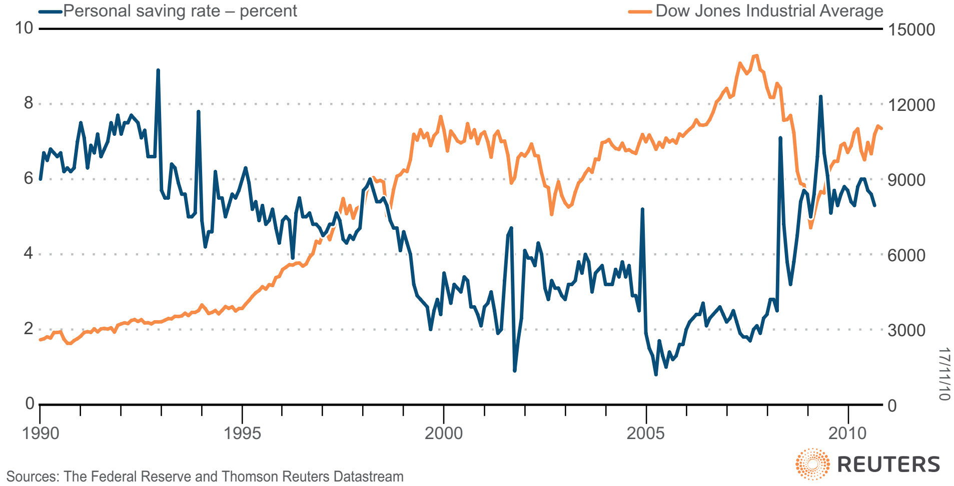
Others point to the aging of America's largest population cohort as the chief culprit.

Brian Reid, chief economist at ICI, started noticing the shift toward more conservative investments in 2006 as a generation of baby boomers began to leave the workforce. After two decades of buying stocks to save for retirement, boomers have been shifting their holdings toward fixed-income assets to ensure a steady stream of money they can live off.

The shift was also part of the fallout from the first crash of the decade, the bursting of the Internet bubble. The recent housing and financial crisis spooked investors even more, and they have been walking away from mutual funds ever since.

Personal savings and the market

When the Dow drops, Americans save more of their disposable income.



Sources: The Federal Reserve and Thomson Reuters Datastream

Reuters graphic/Stephen Culp

CASINO: Traders work on the floor of the New York Stock Exchange October 27, 2010. **REUTERS/BRENDAN MCDERMID**

It is all a far cry from the 1990s, when investors piled money into mutual funds month after month for an entire decade. "Certainly there was an attitude in the '90s that the stock market could never go down, just like there was an attitude in this decade that housing prices could never go down," said Reid. "We've learned those two perceptions were incorrect."

LINGERING IN LIMBO

FINANCIAL ADVISERS AND PORTFOLIO managers frequently speak of a "paralyzed" investor: one that wants to invest money, but is terrified of making the wrong decision. Whereas in the 1990s, investors were convinced they couldn't do wrong, the last decade has made the retail investor much more cautious.

"They've been burned for 11 years and they are just done," said Steve Stahler, financial planner and president of The Stahler Group Inc in Baton Rouge, Louisiana.

Advisers also note the deep distrust many feel toward Wall Street, manifested in the deep backlash against the government bailouts of financial institutions in 2008. A changing market landscape, including a move toward high frequency trading and this year's abrupt "flash crash" -- when the Dow Jones industrial average dropped some 700 points in a matter of minutes -- has added to the complexity the average investor faces.

"I'M MORE WORRIED THAT PEOPLE HAVEN'T SAVED ENOUGH AND THEY HAVEN'T TAKEN ENOUGH RISK."

Whatever the cause, nervous investors are sitting on cash that is making next to nothing from historically low interest rates. And all that dead money may result in too-small nest eggs for many Americans.

Investment advisor Bob Mecca, of Robert A. Mecca & Associates in Chicago, says that the overwhelming concern of people who have about five years until retirement is protecting their initial investment. This partly explains why investors are content to park their money in bonds rather than seek out aggressive gains in stocks.

"The days are gone when older people are searching for the last dime," said Mecca. "They're looking for return of principal rather than return on principal."

Advisers fret that for those with a longer time horizon until retirement, conservative investing may not be the best decision. Lower savings and investments that are returning less than in the past may prove to be the wrong combination.

This is exactly the scenario people like Malkiel worry about. "Many investors have thrown up their hands and said, 'I'm not going to touch the stock market,' and I think they're hurting themselves by doing so," said Malkiel. "I'm more worried that people haven't saved enough and they haven't taken enough risk."

STOCKS ON SALE

THE TRILLION DOLLAR QUESTION for the market is: Does the flight of retail investors matter?

As stocks began to stabilize in 2009, analysts predicted that the floods of retail

BLOG

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money returning to the market would fuel a rally. That didn't happen, but the market rose anyway. As measured by the broad S&P 500, stocks are up about 77 percent from the crisis low hit in early 2008. But the index remains down about 23 percent from October 2007's record high close.

Whether less retail money hinders the actual performance of the market rather than just sentiment is debatable. In theory, an influx of investors looking to hold stocks for the long run should drive up prices and smooth out volatility.

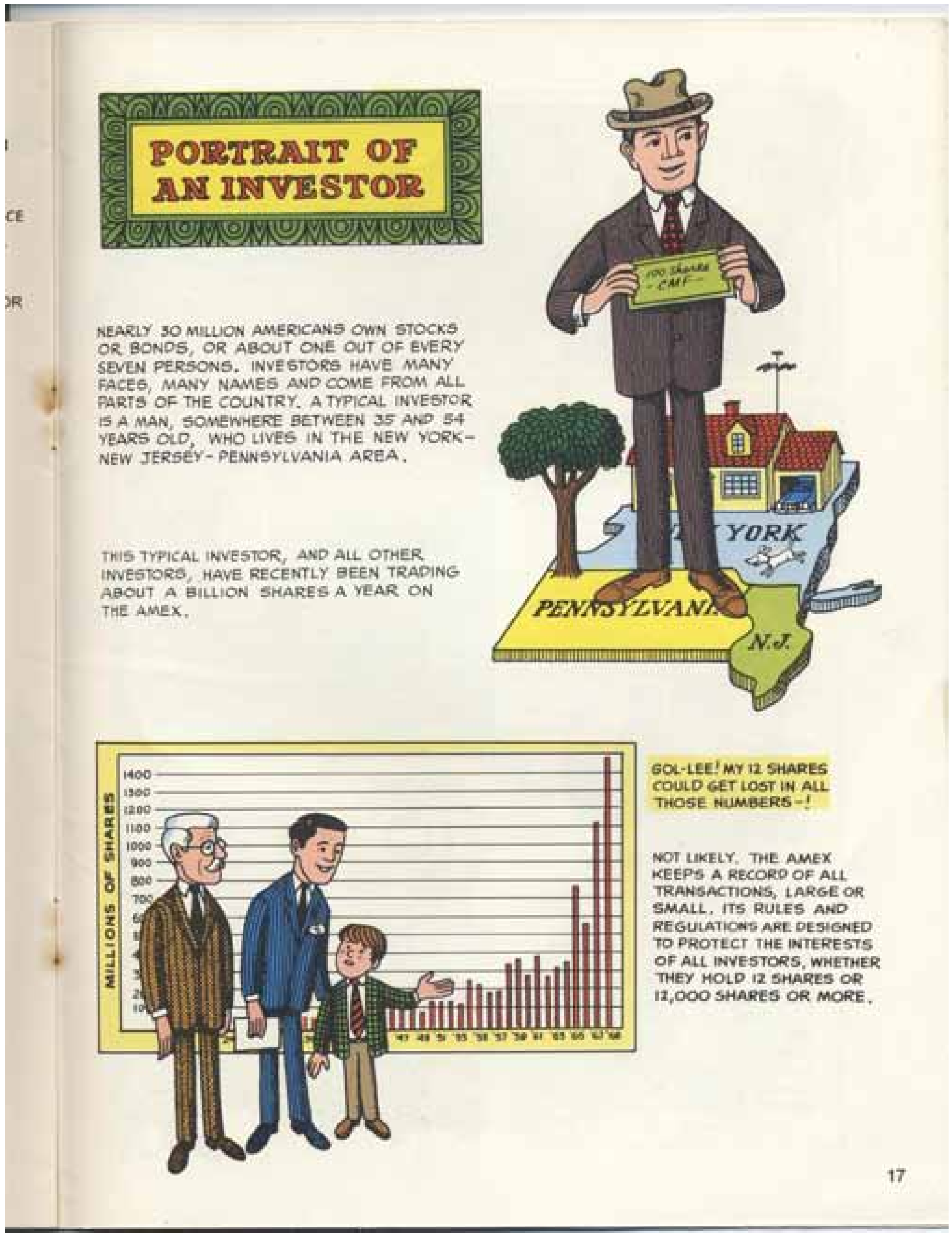
Analysts say the absconding retail investor is also helping to shape the type of market we are seeing: one that is less driven by fundamentals than by traders looking to profit by getting in and out relatively quickly. The end result is a market with low volume and high underlying uncertainty that is easily shaken by news and rumors.

"I DON'T THINK THE FLASH CRASH WAS THE ONLY DRIVER, BUT IT'S HARD TO IGNORE THAT CORRELATION AND IT BEGINS TO LOOK LIKE CAUSATION."

There is a self-fulfilling component to all this. "With retail investors less and less in the game it does come down to a series of more esoteric trading strategies for most of the market," said Nicholas Colas, chief market strategist at the ConvergEx Group in New York, pointing to the upswing in high frequency trading as an example.

Price to earnings ratios, a measure of a stock's value, remain depressed today. S&P 500 companies are now trading at about 12.3 times estimated 2011 earnings, according to Thomson Reuters data. Since 1960 the price to earnings ratio has been about 16.4, according to Bespoke Investment Group, which suggests that stocks today are a relative steal.

"We have had two essentially 50 percent declines in the equity market over the last decade and that has profound impacts on psychology and how people think about equities," said David Giroux, portfolio manager at T. Rowe Price. "And over time that probably puts some downward pressure on equity multiples."



AMERICAN DREAM: An excerpt from a booklet designed to educate children on the benefits of stock ownership, published by the American Stock Exchange in 1970. **Reproduced with permission of the American Museum of Finance, New York**

BLINDED BY THE FLASH

FOR RETIRED COLONEL ROGER POTYK, the flash crash was the last straw. In 2008, Potyk and his wife lost $75,000 on the Lehman Brothers bond they held when the bank collapsed. Even so, the couple held onto their other investments, including stock mutual funds. With the market bounce in 2009 and Potyk returning to work part-time, they were able to recover some of their losses.

But after seeing the Dow sputter in May's unprecedented flash crash, the Potyks pulled their money out of stocks and put it into fixed-income assets.

"It was just a little much for us after being sensitive about the other loss," said Potyk. "We said we'll take whatever we can and be happy, and know when we get up in the morning, it won't have gone up 10 percent, but it hasn't gone down 10 percent, either."

The Potyks were not the only ones shaken by the crash. Weekly data from ICI estimates money came out of mutual funds for 22 consecutive weeks following the flash crash, ending only in mid-October.

Experts say the flash crash is likely just another reason for investors getting out of stocks rather than the only factor. Advisers say clients don't bring up the crash very often, but the data suggests it hasn't been unnoticed.

"I really do think it's primarily driven on sentiment and consumer confidence," said Colas. "I don't think the flash crash was the only driver, but it's hard to ignore that correlation and it begins to look like causation."

Investors who do want to hold stocks have been flocking to stable, blue chip companies that pay dividends and increasingly popular electronically traded funds (ETFs).

Hesitant retail investors are likely to inflict pain on parts of the brokerage industry. Online brokerages like Charles Schwabb are relatively insulated by a core of active traders. But brokers that deal exclusively with buy-side institutions such as mutual funds are having a tough time as retail investors eschew stocks.

Analysts say retail investors will come back once the uncertainty surrounding the economy begins to clear, but even the optimists among them fear that they will not return with the same vigor they once had.

An improvement in the labor market may be the most important catalyst. As long as investors are worried about losing their jobs, saving money and paying down debt will be the priority before saving for retirement.

Dario Caloss, who got out of his mutual funds in 2007, is waiting for the uncertainty to pass before he returns to the market. He had initially planned to get back into the market when the Dow recovered to 8,000, which happened sustainably in May 2009. He admits he's been sitting on the sidelines longer than he planned as he waits for the economy to stabilize.

"This downturn was really about people we were in a position to trust that didn't really do their due diligence. That's kind of shocking," said Caloss. "It's hard to get back in with a lot of faith."

(Reporting by Leah Schnurr and Edward Krudy; Additional reporting by Jonathan Spicer; Editing by Jim Impoco and Claudia Parsons)

GET ME OUT OF HERE: A man passes an electronic board displaying major market indices around the world outside a brokerage in Tokyo October 20, 2010. **REUTERS/YURIKO NAKAO**

COVER PHOTO: Leanne Chase poses for a portrait at her home in Boston, Massachusetts, November 18, 2010. **REUTERS/BRIAN SNYDER**

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