



The Equity Culture Loses Its Bloom

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The equity party is over.

After a 25-year bender in which stocks catapulted Wall Street to such dizzying heights that financial firms managed to tip off a worldwide recession, the cult of equities is declining in earnest. The resulting hangover could fundamentally change the game for Wall Street.

In the 1970s investors were disillusioned by a crushing bear market and high inflation. Large investors for the most part held conservative portfolios that were heavy on bonds and managed by the big banks; retail investors were yet to turn out in full force. The advent of the individual retirement account and other defined contribution plans would change that in the coming decade, creating a new class of investor eager to get into the equity game. In 1985 individuals held \$750 billion in IRA and DC plans; by the market peak in 2007, that number had rocketed to \$9.2 trillion.

But stocks' modern-day surge really began in the 1980s and led to a golden era for Wall Street. The crash of 1987 was a mere blip, after which equities continued their upward climb, nudged forward by a new class of stock investor who became hooked by how equities seemed to outperform other investments, often dramatically. Banks that issued, sold and traded stocks became huge generators of power and wealth, domestically and globally.

Throughout the 1990s venture capital financiers continued to feed the IPO beast. In 1995 there were 921 IPOs worth \$74 billion worldwide; by 2000 there were 2,000, valued at \$209 billion. Private banking expanded exponentially as Wall Street firms stole business from old line trust companies and started managing the wealth of newly enriched entrepreneurs. The banks lured the ultra-affluent by dangling shares of the next hot company and the promise of outsize gains from portfolios heavy in equities — if also laden with fees.

Stocks were king. Neither high costs nor high risks dampened investors' enthusiasm. "The cult of equities is the notion that stocks are special and should be the centerpiece of a global asset allocation, no matter the price," observes Robert Arnott, founder of Research Affiliates in Newport Beach, California.

The momentum continued virtually unabated (apart from the bear market that followed the tech bust in 2000) until the stock market hit all-time highs in 2007. It was a phenomenal 25-year jag for stocks — enriching many investors but also lining the pockets of Wall Street firms. The Standard & Poor's 500 index soared from 131.05 to 1,565.153, or 1,194 percent. "If you questioned the basic notion that equities outperformed everything else, you couldn't get an audience," recalls John Rekenhaller, vice president of research at mutual-fund-rater Morningstar. However, he adds: "There's a lot of skepticism of equities out there today. It's such a contrast to ten years ago."

It used to be simple, recalls Lowell Bryan, a director in the financial services practice of McKinsey & Co. Portfolios were made up of stocks and bonds. Commodities were for speculators and

farmers, not for investors. “Now there are more and more investable asset classes,” he says. “The big trend is that it’s not all about equities anymore.”

Plainly, equities aren’t moribund yet. Indeed, the recent stock market rally has some pundits predicting a revival of the equity culture. But most warn that the current bounceback lacks fundamental drivers. Although stock markets may have rebounded some 60 percent from their early March 2009 lows, investors are still rushing headlong into fixed income and other safer investments. Flows into bond funds are at near-record highs, resembling typical investor behavior in the depths of a bear market.

But it’s not just because investors are jumpy — an increasingly large segment of the population is simply too old to be holding lots of stocks. About 22 percent of Americans, some 68 million people, will reach retirement age by 2020, and as baby boomers start drawing down their assets, they can’t risk wild fluctuations. “They’re saying, ‘We’ve seen two major market crashes in a decade, and this one is even worse than the first — and it’s not over. I’m done,’” says Harry Dent, the author of six books on the impact of an aging population on national economies. For 20 years, Dent predicted a stock market meltdown late in the first decade of this century — that is, now — as the baby boom generation approached retirement. From the 1960s to the 1990s, the U.S. economy benefited as this large segment of the population upped its spending. Now, as baby boomers retire, the trend begins moving in reverse. Certainly, there will always be younger investors with a stomach for risk, but they’re likely to turn increasingly to emerging-markets economies with more growth potential than the more mature U.S. stock market.

And it’s not just demographics pushing money managers to opt for bonds over stocks. New legislation has impelled pension funds to match the duration of their assets to their liabilities, and as a consequence they are adding bonds, greatly downplaying equities and making their portfolios more conservative. The Pension Protection Act of 2006 made corporations pay stricter attention to funding and prevented them from smoothing their plans’ returns over many years. If the plans underperformed, their corporate earnings could take a hit. In response to these pressures, 26 percent of plans have adopted conservative, liability-driven investment strategies, and a further 38 percent are very likely to adopt them, according to a survey by CFO Research Services and Prudential Financial. John Haugh, an analyst from Bank of America Merrill Lynch who covers institutional investors, says this could result in \$300 billion to \$500 billion in U.S. pensions, endowments and foundations money flowing out of U.S. large-cap equities into international markets, alternatives and fixed income.

As more of the cylinders that propel Wall Street’s equity engine sputter, the ramifications for the rest of the financial industry — whose revenue models have largely been built on the issuance, sale and management of stocks — could be cataclysmic: Private banks’ fees will be under pressure as portfolios skew to bonds; brokerage firms won’t have the volume that powers their revenues; investment banks will scramble to replace lost revenue from IPOs, secondary offerings and mergers and acquisitions; and stock exchanges around the world will gravitate toward derivatives and other products — even bonds, eventually — and corporations will increasingly issue more debt whenever they need to raise funds.

“Investors are moving to fixed income, alternatives and international markets,” confirms Jes Staley, CEO of JPMorgan Chase & Co.’s investment bank. “You can see it in our investment banking business — we’re underwriting issues in Asia and Europe, and that more than offsets any structural problems in the U.S. The majority of IPOs have been outside the U.S. This [trend] favors the global investment banks and asset managers.”

Even some of equities’ biggest cheerleaders are sounding somber. Renowned Wharton School finance professor Jeremy Siegel wrote perhaps the definitive case for stock market investing: *Stocks for the Long Run*. Although he sticks by his thesis that equities outperform other

investments over the long haul, Siegel readily admits that stocks are facing grave challenges today. “We’ve had two back-to-back bear markets, the last one the worst since the Great Depression,” he tells Institutional Investor. “You’re getting a lot of disgusted people.”

Another authority on asset allocation and capital markets argues that whether or not stocks pay off over the long haul, they are too volatile for many. “Investors can’t seem to handle the year-by-year risk of equities,” says Roger Ibbotson, a Yale University professor of finance who founded Ibbotson Associates, an advisory firm, which was purchased by Morningstar in 2006. “People are rediscovering the risk of equities.”

Compelling historical data poke a few holes in the notion that equities inevitably outperform bonds long term. Arnott notes that conventional wisdom holds that stocks have offered annual returns of about 9 percent going back to 1802 and that the risk invariably decreases the longer investors hold on to stocks. However, he says, the two harsh bear markets this decade have shredded those shibboleths. As of September 30, long-term Treasury bonds had beaten U.S. stocks over the past 28 years. In February 2009, near the market low, bonds had outperformed stocks over 40 years. Even if the next decade produces high stock market returns, the gains are likely to come with more volatility than ordinary investors — mindful of the 2008 market crash — can abide.

Blind support for stocks represents an “equity cult,” contends Arnott, which he defines as “a group of people who believe something that is based on faith, not based on fact and supporting evidence.” During those 28 years when Treasuries outdid equities, the baby boomers, who were supposed to be accumulating assets for retirement, had a negative risk premium. Investors have been hoodwinked into thinking that equities should form the core of their portfolios, Arnott says, and many put their money to work in the markets over time, such as in a 401(k) plan, leaving them with little control over the price.

But for Wall Street the equity elixir never tasted so good. Firms embraced the stock culture because, quite simply, it is enormously lucrative. Indeed, stocks largely underwrote a historic expansion of the financial services industry. “In a booming equity market, you see more leveraged buyouts, more recapitalizations, more mergers and acquisitions,” says Eric Weber, chief operating officer of New York advisory firm Freeman & Co. Money managers are paid 0.5 percent, and often less, to manage bonds, whereas equity funds reel in 1.5 percent, on average.

Don Phillips, managing director of Morningstar, says the decline of equity is well under way. Bond fund flows are at record highs even as investors lower their exposure to equities. In 2009, American Funds, the second-largest U.S. fund firm, had lost \$21 billion as of October, as investors pulled money out of its equity funds. Bond fund giants Pacific Investment Management Co. and BlackRock had inflows as of October 2009, gaining \$66 billion and \$8 billion, respectively.

Banks’ equity research departments can expect to feel a pinch. “With the decline of an equity culture, there’s an absolute downtrend in the number of people who are going to be employed by investment banks and on Wall Street,” says Paul Zubulake, a senior analyst at independent research firm Aite Group, who has written on the financial services industry’s prospects.

A wave of corporate consolidation could follow, as waning interest in stocks discourages new IPOs, making it hard for smaller companies to get financing. “Large companies will get more and more powerful,” predicts Richard Bove, an analyst with Rochdale Securities who has covered banks for decades. “That’s not positive — American innovation will die out.”

Larry Tabb, founder of the consulting firm Tabb Group, concurs. And he adds that small companies have already been hurt by the reduction in research that was an unintended offshoot of Wall Street investment banks’ settlement in 2003 with regulators over research conflicts.

Without research on them widely available, small companies can't attract investors as readily. "All of these issues are pushing people away from the public markets," says Tabb. "I don't see it changing."

Inextricably linked to Wall Street, corporations are feeling the impact of a declining equity culture. In deciding how to finance themselves, companies weigh what investors will pay for their stock against what terms they can command in the debt markets. And, remember, in 2009 investors have been stuffing themselves with debt. According to Dealogic, they bought more than \$2.9 trillion of new corporate bonds worldwide in 2009 through December 2 — a record. That contrasts with less than \$2 trillion in all of 2008.

Although this won't change the number of outstanding shares in the short term, it could have an impact on stocks' value. And over the longer term, fewer companies will do IPOs, in step with investor preferences, says Clifford Asness, head of alternatives firm AQR Capital Management. "Over time the capital structure can be shifted toward bonds," points out Asness, who used to be the chief of Goldman Sachs Asset Management's quantitative equity group. In fact, as 2008 made clear, the system is already overleveraged, and the government has been encouraging companies to become better capitalized, particularly in financial services. "We have this odd system where the government would prefer more of an equity culture, even as it is waning," says Asness.

Private equity, which had one of its worst years ever in 2008 as leverage evaporated, will suffer as investors increasingly opt to ditch stocks. Cashing out of private companies often means going public. Of course, many are sold to strategic investors as well, and that option will be the primary exit going forward. With an anemic IPO calendar of late, private equity firms have been resorting to shuffling many of their portfolio companies, selling them to other private equity firms in a bid for cash. But in the future companies will have to be larger to underwrite the huge costs of going public in a less heady IPO market. According to a recent Grant Thornton study, the number of publicly traded businesses in the U.S. dropped 39 percent in the past 11 years.

David Richardson, formerly a senior founding partner at fixed-income manager Dwight Asset Management Co., recently formed Global Energy Investors, a private equity firm focusing on renewable energy infrastructure. He witnessed the decline of the equity culture firsthand. At Dwight he observed investors' newfound love of bonds, and now he is seeing another shift in private equity: Investors are transferring some of their private equity investments to infrastructure, which acts like a hybrid of private equity and bonds. Both these shifts are driven by investors' restless search for alternatives to equity. In such an environment banks will behave as they have historically, financing companies through old-fashioned loans. "Capital is moving into more traditional hard assets that produce income," says Richardson. In a less robust equity environment, infrastructure is simply safer. "Equities depend on capital gains," he notes, "but income-producing assets, such as infrastructure, are pretty reliable through different economic cycles."

As investment moves away from equities, speculation will likewise shift from stocks to other investments, including real estate, commodities and currencies. "The money supply won't shrink, and those dollars will need a home," says Bove. Alternatives will continue to attract money from investors' erstwhile equity allocations. Asness says that given the volatility in the equity markets over the past year and some alternatives unmasked as market beta in disguise, investors are now looking for "alternatives that provide true diversification."

As the equity party winds down, the most obvious winners on Wall Street will be those firms that are active in underwriting and managing bonds. Ross Junge, senior vice president of portfolio management at Aviva Investors, says he's never before seen so many fixed-income searches coming from institutional investors. "Few investors anticipated the magnitude of the downturn,

and few will return with gusto to risky assets,” he asserts. In late 2008 and the first half of 2009, many institutional investors, whether they were reducing risk in their portfolios or matching assets and liabilities, were able to buy fixed-income instruments that had the return characteristics of equity but had a fraction of the risk. That was the gift of wide spreads — the extra yield investors received for buying non-Treasury debt. “We see nothing but piles of cash looking for product,” says Jennifer Powers, managing director and head of North American debt capital markets for Royal Bank of Scotland.

Though equities gave Wall Street its power, there’s plenty of money to be made in bonds. In fact, bond trading has provided more revenue to the top banks than equity trading. According to Tabb Group, in the first half of 2009, fixed income made up more than 60 percent of revenues for the top eight banks. And in 2008 global debt markets were 3.2 times the size of global equity markets, up from 1.6 times in 2007. Investors in most countries, including Japan and much of Europe, favor buying stable fixed-income products, in part because many Europeans can rely on robust pension systems and government-provided health care. The need for outside returns on retirement savings is not as urgent as it is in an economy like the U.S.’s. In addition, equity cultures are not as developed in other parts of the world, because regulation favors debt and public companies disdain transparency. Bonds are complex, and complexity translates into cash for Wall Street.

Of course, many skeptics say the cult of equities isn’t waning at all — it’s normalizing. “In the U.S. investors are starting from a massive bias toward equities,” says Jerome Booth, head of emerging-markets investment firm Ashmore Group. “Today’s moves may just be bringing them back to a neutral position.”

For all that, it ultimately remains to be seen whether dumping equities is a sound investment decision. “My belief is that stocks are very attractive now relative to other asset classes,” proclaims professor Siegel. “We’re looking forward to better prospects from here.” Asness happily concurs: “The decline of the equity culture means, all else equal, it’s time to invest in equities.”