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The young and the riskless shun the market

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By Hibah Yousuf and Penelope Wang

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(MONEY Magazine) -- During the years B.C. -- that is, Before the Crash -- Caroline Chesnutt was the very model of a modern young investor.

She started early, at age 24, socking away money in both a taxable account (where she focused on individual companies like Starbucks and Wal-Mart) and a Roth IRA (holding two stock funds). Sure, being 100% in equities was aggressive, but not out of line for her age, and she enjoyed trading several times a month.

Then, in 2008, the bottom fell out of the market.

Though her taxable account was unscathed (fortunately she'd sold her shares shortly before to free up cash to buy new stocks), her Roth plummeted 55% by year-end.

Chesnutt quickly closed the trading account and later cashed out the Roth, moving most of her money to two savings accounts (except for a mandatory 401(k) that her employer invests in a target-date fund).

"I don't want anything to do with stocks," declares Chesnutt, now 30 and a nurse at Vanderbilt University Medical Center in Nashville. "Watching so many people lose all their savings was life altering."

Once bitten, forever shy? That seems to be the new mantra for a growing number of twenty- and thirty-somethings who came of age during the so-called Lost Decade. Like Caroline Chesnutt, they've become skittish about -- and in some cases, even repulsed by -- the idea of investing in stocks.

Today only 34% of people under age 35 say they're willing to take substantial or above-average risks in their portfolios, down from 48% in 2005, according to the Investment

Company Institute.

Meanwhile, a recent survey of affluent investors by Merrill Lynch found that more than half of those 34 and younger described their risk tolerance as low -- a far greater percentage than the 35- to 64-year-olds who describe themselves that way, even though those older investors have a lot less time to recover from market setbacks.

In fact, a new study from MFS Investment Management found these younger investors to be more gun-shy about stocks than any other age group, with 35% agreeing with the statement "After what's happened in the markets the past few years, I'll never feel comfortable investing in the stock market."

The consequence, many experts fear, is that these young adults, mired for a lifetime in low- to no-growth investments, won't amass enough savings to see them comfortably through retirement -- let alone buy a house, put their kids through college, and enjoy a few of life's pleasures along the way.

That's especially true given the challenges this generation faces: They probably won't have pensions and will get reduced Social Security benefits, yet they'll have to make their money last longer than their parents and grandparents did.

"With medical breakthroughs, many of them will live beyond 100," says Yale School of Management professor Barry Nalebuff, co-author of Lifecycle Investing. "The only way younger investors will have enough assets to last them is to invest in stocks."

Of course, not every Gen Y-er is a wimp when it comes to investing, and it's possible that today's discomfort with stocks will yield to an exuberant embrace once a more robust recovery is under way and memories of the meltdown fade. Possible, yes -- but there's good reason to worry that this is more than a fleeting phenomenon.

"We're coming off a series of financial crises that hit this young generation at points in their lives where external events shape strong opinions," says Christopher Geczy, adjunct associate professor of finance at the University of Pennsylvania's Wharton School.

The 2008 crash was just the seismic capper to a series of cataclysmic market events (the dotcom collapse, the real estate bust) that wiped out returns over an entire decade.

Older investors can look back to earlier periods of sustained growth to reassure themselves that stocks are likely to deliver superior returns in the long run. But anyone who entered the market in the past several years has only known disappointment.

"We're a product of our early market experiences, which shape our personality

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and identity as investors," says psychologist Frank Murtha, managing director of the consulting firm MarketPsych.

If the under-35 crowd turns out to be anything like the folks who came of age during the Great Depression, the current bias against stocks could be long lasting.

A study last year examining the effects of major economic events on financial risk taking found that people who grew up in the 1930s were nearly three times less likely to invest in stocks than those who reached adulthood in better times.

And when they did invest, they put a smaller fraction of their money into the market. That held true well into their forties, 20 to 30 years after the Depression had ended.

"Experiences have significant effects-- even decades after the fact," says Stanford finance professor Stefan Nagel, a co-author of the study.

The turbulent market of the past two years has definitely had a profound effect on Shawn Lakhani, 28, a once-avid investor who had about 75% of his savings in stocks before the crash. His portfolio now: 85% cash, 15% stocks.

"To be an investor in today's roller-coaster market is a hard pill to swallow," says Lakhani, a business systems analyst in Yorba Linda, Calif. He plans to invest again eventually but can't bring himself to do it yet: "I'm waiting for a significant downturn or signs of stability before I get back in."

Unfortunately, the wait could prove costly. The greatest advantage that young investors possess is time: The effect of compounding earnings over long periods magnifies savings. The longer they delay, the less they benefit.

Moreover, argue financial advisers like Chris Cordaro of Regent Atlantic Capital, young investors still have an opportunity to get in pretty cheaply -- stocks are trading more than 20% below their 2007 peak.

"It's far more important to focus on buying when stock prices are low," Cordaro says, "than to rehash what's gone wrong over the past 10 years."

If you're a young investor trying to balance your desire for safety with your need for long-term growth -- or you're the parent or grandparent of one and are eager to offer advice -- the following strategies should help.

Twenty-somethings are the least confident among all age groups that stocks are the best place for investment gains and the most likely to choose a bank CD over stocks for retirement savings, according to a new survey from Wells Fargo.

That's a smart strategy if you don't mind eating cat food in retirement but a recipe for disaster for just about everyone else.

Sure, losing money in the stock market is a risk. But the longer your time frame for investing, the weaker that risk becomes: There hasn't been a single 20-year rolling period since 1926 when stocks have lost money, and in most of them the returns on stocks have handily beaten those of bonds and cash investments, according to Ibbotson Associates.

The far bigger threat to your financial health is inflation, even at today's modest 1.2% annualized rate. If prices continue to rise at that pace for the next 40 years, a $100,000 nest egg would be worth only $62,000 in today's dollars. And if inflation heats up to its historical average of 3%, as many forecasters expect, your $100,000 portfolio would be worth just $31,000 by 2051.

"Over the long run, inflation is still the biggest hurdle to affording a comfortable retirement," says planner Stuart Ritter of T. Rowe Price.

Betting primarily on stocks, not bonds or cash, when you're in your twenties and thirties historically has been the best way to get ahead of inflation over the long run.

While it's true that fixed-income returns have outpaced stocks over the past 10 years, those gains have been largely fueled by falling interest rates, which pushed up bond prices. That game appears to be over, says Tom Idzorek, Ibbotson's chief investment officer.

Meanwhile, since World War II, only stocks have consistently outpaced rising prices by a wide margin, delivering inflation-adjusted returns of 5.8% a year, vs. 1.8% for bonds and 0.4% for cash.

Half of eligible young employees do not contribute to their 401(k)s, and among those who do participate, about 40% don't kick in enough to get their employer's full match, an Aon Hewitt survey shows. That's a sure path to nowhere.

But at least twentysomethings do have good intentions: Some 70% of Gen Y-ers say they plan to boost the amount they're investing in the year ahead, a recent Scottrade study shows.

Saving more is critical. The more money you tuck away, the less you have to rely on stock market returns for the growth you need to build a comfortable retirement account, thanks to the power of compounding.

Boosting your savings rate by, say, five percentage points, combined with a modest step-up in your commitment to stocks, may

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enable you to build a larger nest egg than if you load up on stocks when you're young, then gradually shift to more conservative investments as you get older, as conventional wisdom suggests.

Of course, when you're just starting out, saving anything at all can be a major challenge. As a starting point, stash at least enough to take full advantage of any matching contributions your employer offers -- typically that means kicking in 6% of your pay -- then gradually increase that amount as your salary grows.

To get more comfortable with investing in stocks, commit small amounts at first instead of diving in to reach an allocation considered more appropriate for your age. Then gradually increase the proportion of your savings you put in equities.

That's the approach that Brandon Baird, 30, a financial products manager in St. Louis, is following.

Baird, who once had as much as 90% of his portfolio in stocks, now keeps most of his savings in cash investments with minuscule yields; he's too nervous about the possibility of another crash to get back into stocks in a big way. So he's taken an interim step, directing 65% of new contributions to his 401(k) into stocks and leaving the rest alone.

"For now," he says, "this is all I can handle."

All stocks don't move in tandem. To cut the odds of nerve-jangling losses, diversify among several different types -- large and small companies, domestic and foreign, for example -- so that if one sector of the market tanks, you may have gains in other areas to cushion the blow.

Investors who owned assets other than large-company stocks, for instance, have not had a Lost Decade: Over the past 10 years the Russell 2000 index of small-company stocks has averaged gains of 6.3% a year, while the MSCI Emerging Markets Index is up an annualized 12.3%.

Be aware, though, that on a yearly basis small-company and emerging-market stocks tend to have wilder price swings than the average issue. If big changes in value will rattle you, focus instead on less volatile shares-- think established blue chips instead of small up-and-comers, and companies in developed nations rather than emerging markets.

Diversifying among asset categories will also dampen volatility. One easy option: balanced funds, which typically hold 60% in U.S. big-company stocks and 40% in high-grade bonds.

"When the market is up, you earn most of the returns of stocks but suffer smaller losses

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during drops," says Rob Oliver, a planner in Ann Arbor. In 2008, when the average big-company fund lost 38%, balanced funds gave up 25%.

It's not exactly surprising that this generation of texters, tweeters, and smartphone addicts stay overly connected to their investment accounts online. Nearly 60% of Gen Y-ers in the Scottrade study reported they check their accounts several times a week or more (20% check several times a day), vs. just 30% of boomers.

Word to the wise: Cut it out.

Studies show that investors who regularly monitor the market earn worse returns than those who avoid information about their portfolios. Why? News reports tend to overplay the importance of any piece of info, prompting investors to overreact-- they panic and sell at a market bottom or buy in at lofty prices. All of which damages returns.

Blocking out market hysteria will take work.

"Wall Street hype is like gravity -- it's always there, and you have to continually resist it to get where you want to go," says psychologist Murtha.

Help yourself by fighting the urge to check your account each day -- once each quarter is fine. By 2040 yesterday's dip in the Dow will be meaningless. Decades of steady saving and investing won't be.

--Ryan Derousseau contributed to this article.