

The Age of 'Macro' Investing

Sept. 11 Ushered in an Era of Geopolitical Turmoil That Continues to This Day. Here's How Investors Can Protect Themselves

By JASON ZWEIG

Sept. 11, 2001, had only a modest effect on the economy, but the shadows cast over the minds of investors still haven't lifted. The terrorist attacks set the stage for a decade of setbacks that have led many people to regard the stock market as a lost cause.



A protester in Athens raises the Greek flag during a June rally against austerity measures.

Ever since, investment portfolios have seemed to be at the mercy of what professional investors call "macro" forces: natural disasters, geopolitical shocks and sudden, systemic failures of stock markets and national economies, from Hurricane Katrina and the financial crisis to the Japanese earthquake and, now, the unraveling of Europe.

"What was new about Sept. 11 was that you had risk come from outside the markets," says Laurence Siegel, research director at the Research Foundation of the CFA Institute in Charlottesville, Va. In contrast, the stock-market crash in October 1987 and the Asian financial crisis were "endogenous" events, erupting from within specific markets, he says. "This was an enemy from outside that wanted to kill us and managed to do it."

Tips for the Age of 'Macro' Investing

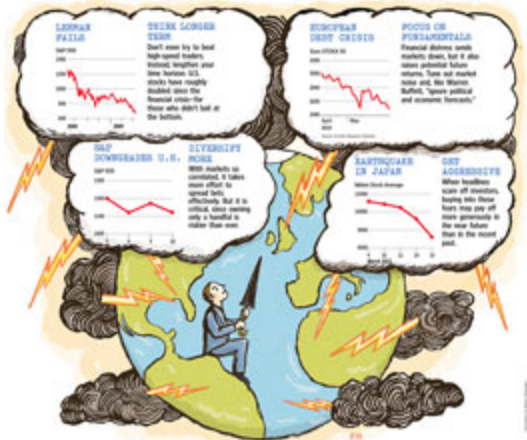


Illustration by Robert Neubecker

The macro-investing decade has taught market strategists and ordinary investors a painful but valuable lesson: **There is a difference between risk and uncertainty.** As economist Frank Knight of the University of Chicago explained in his 1921 book "Risk, Uncertainty and Profit," risk is measurable. The odds of winning on any roll of a fair pair of dice are fixed and known before they hit the table.

For many other kinds of events, however, Mr. Knight contended that "there is no valid basis of any kind" on which to estimate their likelihood.

Sept. 11 and other macro events of the recent past weren't measurable risks; they were uncertainties. And while the haunting imagery of Sept. 11 may have made investors hypersensitive to the recurrence of disaster—and made earlier years seem placid by comparison—**such macro events aren't unusual at all. They are the historical norm.**

For someone trying to manage an investment portfolio for retirement or other goals, the unsettling reality is that you can't inoculate your holdings from macro events. **But by understanding the difference between risk and uncertainty and putting the proper strategies in place, you can control how you respond.**

Long Boom

The 1980s and 1990s were the decades that many analysts have called the Long Boom, when the U.S. economy grew at a robust annual rate of 3% and the Standard & Poor's 500-stock index generated huge returns averaging 18% a year.

American investors grew "kind of arrogant, because we were just so isolated from the real risks in the world, and they never came home to roost in any way," says John Montgomery, chief investment officer of Bridgeway Capital Management Inc. in Houston. "9/11 changed all that."

Sept. 11 also was one of the first major global events to be captured in real time by regular citizens, who used cameras, cellphones and pagers to record the nightmare. Every major geopolitical and financial event since has taken place before our eyes and in the palms of our hands. Each momentary twitch of the Dow is delivered to us instantly through iPads and iPhones, BlackBerrys and Droids.

A survey of investors last month by Decision Research in Eugene, Ore., found that 35% said they had spent at least two hours a day following the financial news during the turbulent markets of early August. An earlier round of the survey in September 2008 found similar levels of obsession.

"The average person lives today in a virtually mediated reality," says Sheldon Solomon, a psychology professor at Skidmore College in Saratoga Springs, N.Y. Thanks to the unfiltered spread of news over services like Facebook and Twitter, he says, "we all get a wide variety of instantaneous images that are likely to have more-inflammatory effects."

Thus, the past decade's miserable returns have made investors inescapably miserable. Since the markets reopened for trading after 9/11, the S&P 500 has generated an annual average total return of just 1% after inflation. Over the same period, the Barclays Capital U.S. Aggregate bond index has returned nearly 6% annually.

"The lost decade [of no real gains in the stock market] could be shaping up as a lost generation of investors," says Rodney Sullivan, editor of the Financial Analysts Journal, a publication for money managers. "People used to buy the dips; now they're selling the rallies."

A Decade of Distress

Standard & Poor's 500, weekly data



Source: FactSet Research Systems

'Lack of Safety'

Yet Americans have felt and acted this way before. In 1951, the Federal Reserve surveyed roughly 3,500 households and asked: "Suppose a man has some money over and above what he needs for his expenses. What do you think would be the wisest thing for him to do with it nowadays: put it in the bank, buy government savings bonds with it, invest it in real estate or buy common stock?"

Savings bonds were the runaway favorite, preferred by 49% of those surveyed, followed by real estate and bank deposits.

Only 6% of the investors surveyed in 1951 said stocks were the wisest choice, with 28% of respondents saying they refused to hold stocks because of their "lack of safety."

And no wonder. In 1951, the Korean War was raging even as nuclear tension between the U.S. and the Soviet Union posed a very real—but utterly uncertain—chance of exterminating much of the human race. That October, almost exactly a half-century before Sept. 11, the great investment thinker Benjamin Graham stated in the preface to the third edition of his classic book "Security Analysis": "The possibility of a third world war weighs heavily on all our minds....The effect of such a war upon ourselves and our institutions is incalculable."

As Mr. Graham's words should remind us, macro fears aren't new. They may well seem more common—and threatening—today than in the past. But that is almost certainly a misperception caused by the nonstop news cycle and the sour mood of investors, says William Bernstein of Efficient Frontier Advisors LLC, an investment-management firm in Eastford, Conn.

If anything, macro uncertainties may be less worrisome now than they have been for much of the past century. Mr. Bernstein points out that the survival of capitalism itself was in substantial doubt from 1929 through the mid-1960s and that the launch of thousands of nuclear warheads was only a button-press away for decades.

"Two generations ago, the U.S. endured a global conflict that cost 50 million lives," Mr. Bernstein says. "The next generation faced down the Soviet Union and its 20,000 nuclear warheads. If you had told Americans then that the U.S. should someday be even more afraid of a handful of jihadis from countries that couldn't even make their own bicycles, they'd have keeled over laughing."

Put Fears in Perspective

So how should investors respond in a world where macro events seem more common—and threatening—than in the past?

First, put the fears in perspective, taking a cue from the great investor Warren Buffett.

"We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen," wrote Mr. Buffett in his 1994 letter to shareholders of Berkshire Hathaway Inc. "Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks, the resignation of a president, the dissolution of the Soviet Union, a one-day drop in the Dow of 508 points or Treasury bill yields fluctuating between 2.8% and 17.4%."

Added Mr. Buffett: "We have usually made our best purchases when apprehensions about some macro event were at a peak... A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor to profit from them. If we can identify businesses similar to those we have purchased in the past, external surprises will have little effect on our long-term results."

Now more than ever, investors should remember the sage words of Adam Smith, the pen name of journalist George J.W. Goodman. He wrote in his 1968 book "The Money Game": "If you don't know who you are, [Wall Street] is an expensive place to find out." In a world where fear warps perceptions of risk, it may be a long time before owning stocks is no longer a painful ordeal. If you have a low tolerance for that discomfort or you are in or near retirement, then you should almost certainly reduce the proportion of your assets you have dedicated to stocks.

Take Selective Risks

On the other hand, if you have endured the stock market's lost decade with grim determination, then don't stop now. Many strategists think selective risks will pay off more generously from now on than in the past.

Elroy Dimson, emeritus professor of finance at the London Business School and an expert on long-term stock returns, argues that "exposure to factors like illiquidity, credit, natural disasters and insurable events [will be] better rewarded than in the last century." Investors with the cash and the courage to step in and buy individual stocks and even entire markets in the face of short-term bad news may well earn premium returns in the long term.

Not all of those stocks are at home. Companies based outside the U.S. make up only about 29% of total assets in stock mutual funds and exchange-traded funds, according to data from Morningstar Inc. Yet non-U.S. stocks make up 58% of the total value of global stock markets, meaning that many American investors could substantially raise their holdings of international funds, Efficient Frontier's Mr. Bernstein says.

With emerging markets such as China, India and Brazil down an average of more than 12% so far this year, European stocks off more than 18% and fears swirling that the U.S. dollar may continue to deteriorate, it makes good sense for U.S. investors to continue raising their holdings of overseas stocks, especially if Europe and Asia get cheaper.

If you prefer to pick your own stocks or mutual funds that might outperform the market, be aware that diversification takes more work than it used to.

Because so many mutual-fund managers failed to protect their shareholders against the calamities of the past decade, index funds—which passively replicate the performance of entire markets—have come to dominate the scene. These funds mechanically buy (or sell) hundreds of stocks at once, increasing the extent to which stocks move in lockstep.

It thus takes roughly 40 large stocks today to equal the diversification benefit investors got from just 20 stocks in the early 1990s, warns Mr. Sullivan of the Financial Analysts Journal. Anyone who doesn't use index funds should be aware that portfolios of only a handful of stocks are more prone to sharp fluctuations than ever.

Nor are stocks substantially more volatile than they have been in the past; they only seem that way. Notwithstanding the frighteningly sharp drops in stocks last month and in May 2010, the market's surges up and down have been no more extreme in the past few years on average than they were in the 1930s, and barely any worse than they were in the mid-1970s.

Today, however, every fibrillation is recorded in real-time pulses, making it unbearable for many investors to watch their account values fluctuate—and thereby shortening their horizons. But you will never be able to outperform professional traders who have high-speed computers and special access to market data. Instead of trying to shorten your horizon to compete with them, lengthen it.

Bear markets may be gut-wrenching, but they are the only means by which future returns can be raised.

Write to Jason Zweig at jason.zweig@wsj.com

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