Is the Retail Investor Returning to U.S. Stocks?

Advisers say investors less fearful of stocks
More advisers encourage clients to boost stock holdings
A rebound in small investor appetite could extend rally

By Joseph A. Giannone
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NEW YORK, Jan 3 (Reuters) - U.S. stocks just posted back-to-back years of strong gains, yet the small U.S. investor largely remained a spectator. Now financial advisers say investors, many of whom rode out the financial crisis in cash and bonds, are slowly regaining confidence.

"What I'm seeing now is there's a lot more talk about getting into stocks," said David Gottlieb, a Cleveland adviser for Edward Jones, a nationwide brokerage catering to middle-class Americans.

Gottlieb, who for several months has encouraged clients to increase their stock allocations, advises reducing bond holdings and buying dividend-paying stocks.

The Standard & Poor's 500 Index .SPX kicked off the new year by rising 1.1 percent on Monday, reaching levels not seen since the weeks before Lehman Brothers collapsed in September 2008. Large company shares, as a group, have nearly doubled since their March 2009 lows, reflecting two years of double-digit gains.

Worries of a banking system collapse and the deepest recession in more than 70 years drove many retail investors out of the stock market back in 2008. And the May 2010 "flash crash," when stocks lost 700 points in minutes for no apparent reason, further undermined confidence.

Investors showed their dismay by pulling money from stock mutual funds month after month, opting for the perceived safety of cash and bonds.

CONFIDENCE

But 2010 ended on a high note, giving investors confidence to start buying stocks again. The returns from bonds have also started to look more questionable after a sell-off at the end of last year.

And some advisers contend that the stock market recovery is far from over.

Todd Morgan, chairman of Bel Air Investment Advisors in Los Angeles, one of the largest U.S. wealth managers with $6 billion in client assets, said stocks have climbed "a wall of worry" for two years and yet clients are still underinvested.

"I've been calling clients for three months to put more money in equities. It's a slow, arduous process, but they're starting to come around," he said. "I think it is the cheapest financial asset out there and will continue to outperform bonds."

Morgan stressed that while there is more talk about buying equities, market data indicates people are not yet buying.

"When you see more liquidation of bond mutual funds and investment in stock mutual funds, then I'll get cautious about stocks," Morgan said. "The small investor is not there yet, and I don't see him getting there for a while."

According to Investment Company Institute mutual fund flow data, investors withdrew funds from domestic U.S. stock funds in nine out of 12 months last year, roughly $81 billion over all.

By comparison, investors added $254 billion into bond funds last year, though the final two months saw net withdrawals, according to ICI.

Money market fund assets have fallen from their early 2009 peaks, but $2.81 trillion was still parked in these low-yielding vehicles at the end of December.

The bulls acknowledge there are still plenty of stumbling blocks, including a weak U.S. dollar, the mounting federal deficit and continued economic weakness.

"We had two strong years despite net fund outflows in every month except December, and despite the worst recession in decades," said Aaron Skloff, whose Skloff Financial Group in Berkeley Heights, New Jersey, manages money for individuals. "What's going to happen when the tide turns, confidence resumes and money starts coming back in?"

CAUTION

Still, some advisers are being very cautious.

William Jordan of William Jordan Associates in Laguna Hills, California, says he is telling clients not to increase their stock exposures.

"As good as the past two years have been, you can't say the stock market is undervalued. I'm not bailing out, but I'm advising people to take some profits."

Clients also are encouraged to stick with their investment plans. Scott Smallman, a Seattle broker for Wedbush Securities, said he has been checking to see if the stock market rebound has pushed some stock exposures too high.

"When markets are good, our job is to talk clients down from the ceiling," said Smallman, who on Monday encouraged some clients to consider buying municipal bonds.

Other advisers, though, remain optimistic on the outlook for U.S. large company shares.

"The world is getting better, the financial system is healing. I would not bet against the U.S.," said Kevin Peters, a Morgan Stanley Smith Barney (MS.N: Quote, Profile, Research, Stock Buzz) adviser in Purchase, New York, whose wealthy clients collectively have more than $1 billion with the firm.

Peters warns there will likely be market swings this year and stock prices could pull back at any time. The recent rally in stocks may attract small investors who would extend that rally. Even with the rally, stocks are still down about 20 percent from highs in October 2007.

"If even a little bit of that (retail) money moves out of risk-free assets into growth assets, that's a whole 'nother leg of the market recovery," said Peters. (Reporting by Joseph A. Giannone, editing by Matthew Lewis)