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STOCKS AND BONDS

Practically Speaking, Stocks May Be a Good Bet

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Wealth Matters

By PAUL SULLIVAN

AFTER a nice run, the stock market looks a lot like the movie "Jaws 2": just when you thought it was safe to go back into the water... (cue the menacing music). But before the concern about Greek debt and the wild ride the stock markets took at the end of last week, I had begun to hear people talking up stocks again.

Data from the Investment Company Institute, which tracks money into and out of various funds, verified my hunch. Money left equity funds in each of the last four months of 2009, but flowed in the first four months of this year. The numbers were not staggering but they seemed to be a first step.

Some wealthy investors are still shying away from the stock market, but others consider the recent yo-yo streak a blip and are thinking more seriously about equities. Those putting their money back into stocks need to understand that markets are going to be increasingly volatile, advisers said. That is influencing how they are picking stocks but it is not stopping them.

"People got bullish and then we had this quick and very painful 8 or 9 percent correction," said John Maloney, chief executive of M&R Capital. "As slow and painful as this recovery is, we're not likely to have a double dip."

But what will we have? Even if there is no double dip, there are still many questions about the stock market, where big and small investors not so long ago boasted about their winners and forgot their losers. For anyone trying to decide what to do, here is a look at some of the debate about equities.

WHY NOT BUY STOCKS NOW? One school of thought says equities are a great value. “U.S. stocks in aggregate represent the cheapest asset class in the world today,” said G. Moffett Cochran, chief executive of Silvercrest Asset Management, with $9 billion in assets. “We’re saying to clients ‘We’d urge you to increase your allocation.’ ”

But the rational argument is a hard sell. “People want to believe this, but people are very skeptical,” Mr. Cochran said. “What they’ve learned from first-hand experience is those things that can go up can also go down, and they can do down abruptly.”

Leo Grohowski, chief investment officer at Bank of New York Mellon Wealth Management, put it more bluntly: “Investors should be entering into the market with a strong stomach.”

For others, this uncertainty has put stocks in the category of a cyclical trade: there may be some money to made on them in the short term, but be careful. Richard Cookson, global chief investment officer at Citi Private Bank, subscribes to this point of view. He said companies looked profitable — and their stocks good — not because of any fundamental improvements but because they had cut costs by laying off workers.

Mr. Cookson said that stocks over the long term could be a tough investment, but he is a pragmatist. “You can be right over the very long term but you can get killed in the short term,” he said. “My argument is not that you don’t buy equities, but it means you have to be quite careful when you sell.”

This is not exactly a rousing endorsement of stocks right now, but Mr. Cookson said he believed that stocks could offer a good return over the next six months.

SMALL, MEDIUM OR LARGE? There are plenty of money managers, not surprisingly, who are far more bullish on stocks. But like the story of the three bears, the managers have different views of which ones are just right.

Nick Galluccio, chief executive of Teton Advisers, has $300 million of the $600 million he manages in small- and micro-capitalization stocks. He said these stocks outperformed those from large-capitalization companies over the last decade by 9 percent. And he argues that smaller companies — those with market capitalizations of $200 million to $2 billion — will grow more quickly as the economy recovers because they often supply larger companies.

At the other end of the spectrum is Mr. Maloney, who manages $450 million at M&R Capital. He says he believes that large cap stocks will have both steady growth and low volatility in the future. He reasons that because these companies are multinationals, they can protect themselves from any slowdown in the domestic economy.

In between the two is Richard Madigan, chief investment officer of the $9.2 billion Global Access Portfolio at J. P. Morgan Private Bank. He agreed that large cap stocks could benefit from a global recovery and said he liked small caps last year but felt they had had their run. Now, he prefers stocks in companies between the two extremes. His reason is that the midcap sector is guided more by fundamentals. “It’s a less aggressive sector and not driven by momentum like large caps,” he said.

That reasonable arguments can be made for three different types of stocks will not clear up investors’ uncertainty. Even Mr. Grohowski, who has set a year-end target of 1,250 for the Standard & Poor’s 500-stock index, acknowledges that theories on sectors and predictions on indexes carry less weight with investors than they used to.

“Investors have a right to be skeptical,” he said, adding that investors have been more receptive to pitches on quality, dividend-paying stocks like Pepsi or ConocoPhillips than overarching theories. “There’s a high-degree of skepticism with top-down forecasts but also around past performances.”

This is where the stock pickers come in. William Priest, the founder of Epoch Investment Partners, which manages $12.5 billion, is focused on what he calls “shareholder yield.” Instead of choosing stocks based on the traditional criteria of dividends, earnings and price-to-earnings ratios, he looks at how companies maintain and use the cash on their balance sheets.

“Earnings are an accounting artifact,” he said. “It’s all about cash flow. When Bear Stearns went broke, it had a book value of $60 per share. Cash doesn’t lie.”

Most of the stocks he likes for this strategy are large cap, but he said he had been able to create a stable portfolio that aimed for a 9 percent return, no more, no less.

ROUGH RIDE Regardless of how you go about buying equities, the consensus is that the rest of the year will probably be full of peaks and troughs.

“We’ve probably seen the low in volatility for the year,” Mr. Grohowski said. “It’s going to be choppy and uneven from here.”

He pointed out that the S.& P. neared his year-end prediction of 1,250 when it closed at 1,217 on April 23. On May 7, two weeks later, it closed 100 points lower. This leaves investors three choices: Remain on the sidelines while understanding that market timing is impossible, have a long-term strategy and accept the volatility, or try to mitigate the swings.

Wasif Latif, vice president of equity investments at USAA’s investment management unit, said he had seen a lot of interest in equity hedging to lessen and possibly profit from stock swings. He said USAA’s Global Opportunities Portfolio — which uses a simple strategy of creating bands, or collars, around stocks to manage how much they can rise or fall — went from essentially zero to $500 million in a year.

“We’re getting money in because of the psychology in the market,” he said. “We’re trying to get market exposure but limit the downside.”

This isn’t exactly a bullish sentiment. But it is a practical one.

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