With Stocks, the “Enemy Is Us”

By Editor Test *Wed, Nov 11, 2009*

Investor sentiment leads rather than follows the market, two economists say. And that may make stocks fundamentally risky.

In a provocative new series of Issue Briefs, the Center for Retirement Research at Boston College will examine whether stocks are suitable as long-term investments for savers. In doing so, the Center is challenging the conventional wisdom that stocks are the best long-term investment, not just for young investors but even for those who have recently retired.

The first brief, by economists Richard W. Kopcke and Dan Muldoon, asserts that “variations in business activity and profits account for a relatively small share of the risk in stocks over holding periods as long as 10 years. Instead, variations in shareholders’ valuation of earnings account for most of the volatility of returns.”

The brief, entitled “Why Are Stocks So Risky?” also says that 10 years may not be an adequate time horizon for investing in stocks, contrary to popular belief.

“The risk attributed to valuations of earnings tends to diminish over investment horizons as long as 40 years or more, because the value of stocks broadly follows the trend in GDP and corporate profits,” the authors said. “Although stocks are better investments for the very long run, these periods can seem too long to suit savers who lack the capacity or the willingness to absorb significant financial risks in the interim.”

In a section entitled “We have met the enemy and it is us”—a reference to a 1971 comment by the opossum Pogo from Walt Kelly’s comic strip of the same name—the authors suggest what John Maynard Keynes is said to have believed: that investor behavior rather than corporate fundamentals cause most of the stock market’s ups and downs.

“Shareholders’ reactions to economic conditions and to recent trends in stock prices create most of the volatility in the returns on equity,” they said. “Although stock prices vary substantially in response to cycles in business activity and earnings, these factors account for a small share of the risk in stocks over holding periods as long as 10 years or more.”