

KEYSTONE FINANCIAL PLANNING

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Where to find real stock market value

Many investors have a vague notion that “small” stocks and “value” stocks are something they should consider for their portfolios. Yet the average investor’s portfolio is often more “market-like,” that is, invested in big U.S. growth stocks. So where do value and small stocks fit in and why would an investor want them? The answer is very important for long-term investors who want to do as well as possible. In one sense, the answer is also simple: small and value stocks are expected to offer higher average returns than the market over long periods of time.

Research first published in 1992 and confirmed by several studies since then indicate that company size and a value factor (the book value to market capitalization ratio, for finance geeks) are the two most important factors that explain the variation in returns among stocks. Simply put, small stocks and value stocks have higher average returns than the market and this phenomenon appears to be related to the risk of investing in such stocks. Finance professors Eugene Fama and Kenneth French looked at the returns of different parts of the market and found that small cap stocks had higher compound returns than large stocks, while value stocks had higher compound returns than growth stocks.

This seems counter-intuitive. Big and profitable growth stocks that are increasing their earnings rapidly would seem to be a better bet than smaller, unknown companies or those that are struggling with their profitability. Indeed, Fama’s and French’s research showed that value stocks and small stocks had lower earnings and experienced more financial distress than did growth stocks. Their conclusion was that the increased risk of small and value stocks had to be matched with higher returns, or else investors would not invest in them. That’s why such companies have to pay higher interest rates on their bonds than do big, established growth companies—they have to compensate bond buyers with higher returns in order to induce them to risk their capital.

Investors who want to participate in these potential higher returns have to diversify away from the typical portfolio or stock mutual fund that resembles stock indexes such as the Standard & Poor’s 500 Index or the Russell 3000 Index. Those indexes are dominated by large-cap growth stocks.

Fama and French and others have confirmed that the size and value effects hold true in overseas stock markets as well. Investors who want to diversify their portfolios by holding foreign stocks should also consider small and value stocks, rather than the large stocks that make up the EAFE (Europe, Australia, Far East Asia) index. That index is also dominated by large growth stocks and its returns are closely correlated with the S&P 500.

There is a danger, however, in relying too heavily on small and value stocks, the research indicates. Small and value stocks exhibit a high degree of variability of returns over time, and that variability can last for many years, even decades. For instance, the extra measure of return offered by small stocks declined from 1984 through 2001, while the extra premium for value stocks declined from 1988 through 2000. Investors who concentrate on small and value stocks may find themselves underperforming the stock market for many years.

Research indicates that large concentrations of such stocks are not appropriate for investors who have investment time frames of less than 20 years. Shorter-term investors should consider more market-like portfolios to reduce risk.

Low savings rate threatens American retirees

Despite all the attention being paid to the problems that may be caused by the imminent retirement of the Baby Boomers and the threat to Social Security, most Americans still aren't saving enough money for retirement. A new study identifies groups that are most at risk for income shortfalls in retirement. Number one on the list is the low-income single woman, who faces not being able to meet nursing home and home health costs, the study found.

Retirees in this country face a total estimated income gap of \$45 billion by 2030, says a study by the Employee Benefit Research Institute and the Milbank Memorial Fund. The study looked at the savings and retirement benefits of various age groups, income groups, and marital statuses. For the first time, the study shows how various groups will fare in retirement as they draw income and benefits from Social Security, Medicare, Medicaid, pension plans, and individual retirement accounts.

The forecast isn't all bad. Many middle-income Americans will be able to retire in reasonable comfort if they save just 5% of their earnings in addition to savings and benefits already accumulating in existing retirement vehicles. Younger workers have the best chance of retirement success through additional savings. Couples and those in higher-income brackets also are predicted to do better.

However, single women will have a tough time. The average low-income single woman needs to save an almost impossible 25% of salary, the study found. Women especially should also consider long-term care insurance for themselves and their spouses. Their longer life spans will make them more vulnerable to income shortfalls, especially if their spouses deplete assets to pay for a nursing home stay, leaving women with little for their own care. Such shortfalls cannot be made up with the proceeds from sale of a home or a reverse mortgage, the study said.

The retirement income shortfalls could have a serious impact on employers who won't be able to persuade older employees to retire, while the economy may suffer if the buying power of retirees begins to decline, the study's authors said.

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