

Think twice before shifting to 'safe' investments

After a year of relief, the sentiment of investors has shifted over the past couple of weeks. Investors are increasingly asking, "How can I avoid risk? I'm nervous about the market correction."



Gary Brooks

It's easy to understand these thoughts given that the U.S. stock market declined 11 percent in just five weeks entering June.

International markets have fallen even further because of debt problems in Europe and a bear market in China. And certainly, the largest factor is the fresh memory of the Great Recession which has been over for a year but has left lingering damage.

Human nature dictates that we fear loss more than we appreciate gain. Therefore, quick downturns often cause nervous investors to try to outmaneuver markets. Frequently, this behavior is more detrimental to their progress toward financial security than is the actual market activity. This turns many investors into market timers trying to guess direction or market swings.

Instead of managing risk by investing in a diversified portfolio aligned with their goals, they try to avoid risk as a protective measure. They retreat to perceived safety. Lately, gold and bonds have drawn safety seekers. But each new dollar entering these investments should have to

pass a caution flag. These are not risk-free assets. Global stock markets might be waving a yellow flag as well, but that caution is largely expected.

Before shifting assets in search of safety, consider the following three specific cautions:

Government bonds lose value more frequently than stocks.

Ibbotson Associates research shows that, since 1945, government bonds as a whole have declined in value in 19 calendar years. That's four more negative years than the S&P 500 index of U.S. stocks. Of course, the magnitude of stock market declines is more severe. However, the reality that government bonds have declined in value 25 percent of the time over the past 65 years is an eye-opener.

Cash flowing into bonds is creating a bubble.

While stock markets raced upward, a massive majority of cash flow into mutual funds actually was put into bond funds. Global stock markets began their recovery rally in March 2009. Intuitively, it wouldn't be surprising to have seen money flow back into stocks since then.

But between the beginning of April 2009 and the middle of May 2010, risk-averse investors contributed \$447 billion into bond mutual funds.

That's more than the previous seven years combined and more than eight times as much as the net cash flow into stock funds over the 13-month period.

This expanding bubble will be hard for markets to support, especially when interest rates climb from their current historic bottom.

Gold momentum isn't likely to keep up the pace.

Global debt problems have extended the momentum that gold has built over the past decade. Investing in gold 10 years ago would have been extremely profitable. Investing in it now might still yield positive returns, but there is a real risk of buying close to a high.

The gold rally is one of just two significant upward moves in the past century. The previous was in the late 1970s and into 1980. Remove the two rallies and, for the most part, gold has produced less inflation protection and real growth than you would expect.

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