MONEY

After wild 2011, where do we go from here? ; Recommendations from the roundtable pros

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The outlook for U.S. stocks next year is not wildly bullish. Nor is it depressingly dreary. The buzzword is "cautiously optimistic," say six top investment strategists and fund managers who took part in USA TODAY's 16th annual Investment Roundtable. The main source of trepidation is Europe. How its debt crisis plays out will largely dictate whether markets thrive or dive. U.S. politics could also move markets as the election nears. The good news? Barring a "shock," a recession is unlikely. What's ahead in 2012?

Q: Is it possible to make money in a world dominated by debt, deficits and doom and gloom?

Kate Warne: Yes. I will give you two reasons why. The first is, if you put money in at the stock market peak in October of 2007, and you owned 65% stocks and 35% fixed income, you actually would have been up 10% at the end of November. All you needed to do is rebalance your portfolio once a year. People have been really nervous. But if you stayed invested in a normal (balanced) portfolio of stocks and bonds, you did fine.

Second, the pessimism today is actually creating opportunities for investors. There are a lot of short-term concerns, a lot of serious risks, but investors really need to keep their eyes on the horizon, because we are also seeing strong fundamentals (such as strong profit growth from Corporate America and better economic data, including better news on the jobs front). And that is what is driving the market longer term. I am cautiously optimistic.

Q: Bob, are you optimistic about 2012?

Bob Doll: Cautiously optimistic. Europe is the main show on the stage. Everything else is a sideshow. And that is probably the case until we get a little more clarity there.

Can you make money? The probabilities go up depending on your entry point. And the entry point now is low expectations and pretty reasonable valuations. (Editor's note: The Standard & Poor's 500 index is trading at roughly 12 times next year's estimated earnings, says S&P Capital IQ, which is below the average P-E, or price-to- earnings ratio, of 15.) Look at October and how strong that was (the S&P 500 rose nearly 11%). We did not get good news; we got less bad news. I think if we get some more of less bad news, it will allow us to make some money in stocks.

Q: Ann, do all the fears make your job more difficult as a stock picker?

Ann Miletti: The volatility makes it difficult, but the fact that expectations are low is the best thing we have going for us. People are afraid, and there is a lack of confidence. But that is when you actually want to put money to work. When there is comfort and euphoria, that is probably when you want to start selling. There is a lot of uncertainty in Europe, as well as domestically with our deficit and upcoming election year. But once we have all of the answers, it will already be priced into the market.

Q: Rich, what's your outlook for next year?

Richard Bernstein: Investors have always been able to make money. People still talk about the lost decade in equities. That is absolutely wrong. The question is: Where did you invest?

If you go back 10 years ago, people were all excited about the U.S. and technology. People thought this was the place you had to invest, and the next 10 years turned out to be completely different. Emerging markets and commodities outperformed.

And most investors today are still talking up emerging markets. So now we have people again believing that what has worked is where they should be putting their money. People are setting themselves up for another lost decade. The reason I say that is people don't understand that the S&P 500 has now outperformed the BRIC nations (Brazil, Russia, India and China) for four years.

We are in the very early stages of a resurgence of the U.S. equity markets, and I don't think people are aware of the shift that is going on.

Q: Tom, your optimistic outlook for 2011 didn't come to fruition. Is your bullish investment thesis still intact?

Tom Lee: As I look back at the 2009-10 bull market, it made a lot of sense to be contrarian and bet against the pessimism. But this year, because the European crisis really intensified, it made sense to kind of go with the crowd. But 2012 is really setting up to be a year to be a very big contrarian and (bet against the negativity again).

Q: Why do you think stocks will rise despite the ongoing angst?

Lee: We are seeing the endgame develop in Europe. (We are) betting on Europe finding a road map. (Our bullish market call) is a little bit like buying a semiconductor stock two quarters ahead of the inventory turn. I think next year people might be talking about Europe exiting recession rather than talking about entering it this year.

The U.S. market will also be driven by corporations buying back their own stock. Corporations have been the real buyer of stocks over the past decade. Buyback activity was up sharply this year. (S&P estimates buybacks for its benchmark stock index will hit $439 billion in 2011.) And buybacks might be up sharply again next year. (S&P estimates $500 billion next year.) That would represent a historic inflow into equities in 2012.

Political outcomes also favor equities. It is generally a good time to buy stocks when presidential ratings are low, as Obama's are now. There have been eight election years when the president's approval rating was below 50 at the start -- and all but one saw gains. Low approval means markets see a change in office, which is good for stocks. If the economy recovers and the incumbent wins, that's also good for stocks.

Q: Dan, is there opportunity to make money in growth stocks?

Dan Chung: Investors seem very frustrated this year. The headlines, of course, have been grabbing a lot of attention: Budget talks in the U.S. that have gone nowhere. A supercommittee that was anything but super. The European crisis. A nuclear accident in Japan, and rising protectionism across the globe. And yet the U.S. markets are essentially flat and among the best markets in the world.

Q: The market held up mainly because corporations grew earnings more than 15%, right?

Chung: Companies in the S&P 500 have proven that they can earn about $100 a share, which (means the market sells at) 12 times earnings and has a dividend yield of 2.5%. It is an excellent period for investors with patience to be strategically looking at the opportunity in U.S. stocks.

Q: What's your bear -- and bull -- scenarios?

Chung: Here's my way of looking at the bear case. The great fear is that we see a significant U.S. recession where earnings decline, say, 20%. The S&P 500 companies are earning $100 a year now, so profits will fall to $80.

Then the question is: What should the market be priced at $80 in earnings? You can take a 12 multiple and you get down to 960, (which is 21% below Thursday's close of 1216). But when you get that depressed you really should have a higher P-E multiple. (That's) because the market looks forward and has seen the profit recovery and resiliency of American companies in the last two scary recessions -- one following the tech stock bubble bursting 10 years ago and the financial crisis a few years back. So the P-E multiple shouldn't be 12 on $80 of earnings if we had a serious recession; it should be 15. And that gets you back to 1200 (basically where the market is trading at now). There is not that much downside. That's not to say that in a sentiment-driven market, we don't get to 960 briefly if markets (react badly to events in Europe).

Q: What's your bullish thesis?

Chung: It doesn't take much to get significant upside if we get past the euro crisis, and Europe's resiliency surprises us a little bit and they make some progress through some of the reforms that they need to make. More important, (it will also help) if the emerging markets, where regulators and policymakers have been tightening policy in attempt to constrict the bubble, start to ease (i.e., lower interest rates and borrowing costs). There is, of course, risk of a contraction. But the markets will respond going forward to growth-supportive policies. And I think there can be a surprising restoration of investor confidence, just like we saw in 2009 and 2010.

Bernstein: To just add one thing on investor confidence. People have to realize that the major bull markets in history have never begun with investor confidence. If you go back to 1982 (the start of the biggest bull market ever), people were not saying, "Oh, we have to be in stocks." People were saying, "We have to be in money market funds" because the interest rates were so high.

Q: Political gridlock in Washington hurt investor confidence and held markets back this year. A partisan fight over raising the debt ceiling this summer and lawmakers' inability to agree on a plan to reduce the nation's $1.5 trillion deficit cost America its gold- plated triple-A credit rating. What impact will the 2012 election, politics and policy have on financial markets next year?

Lee: (Throughout) history, Washington has always been a headwind to markets. It has never really been a tailwind.

Doll: Shut it down.

Chung: Let's occupy Washington.

Lee: There is a real frustration among businesses because Washington's regulations and tax policies have made it difficult for them to make capital decisions. So I do think that in 2012 there is potential for a pretty big voter revolution. For big business the optimum outcome is probably a Republican Senate, House of Representatives and a change in president. But I think that it's going to be very tough for all of that to take place. But markets are discounting mechanisms, and I think things couldn't be worse in Washington than they are today. There is a real sense of paralysis and frustration.

Q: What if Washington strikes out again and causes market confidence to deteriorate further?

Chung: That's Scenario C, the super bear, which is if the Europe crisis plays out (positively) and markets rally. But it gets cut off because of Washington, and an extreme rise in protectionism across the globe. It would be like a reversal of globalization, one of the biggest forward trends of the past 20 years.

Doll: One of the surprises in 2011 is that we have not had more of that sort of thing. Growth is slow. The politicians want to be re- elected. You know, protecting the jobs of the workers in my region - - all of this protectionist sort of outcry.

Warne: I think we will see no steps forward but probably no steps backwards. Globalization is actually hard to reverse. We will see more cries for protectionism. But I think it takes awhile before those actually become actions.

Q: Will the U.S. political scene be a headwind or a tailwind next year?

Doll: Less of a headwind than it was. Why? There will be a lot of debate. Not much will get done.

Q: But some argue gridlock's not good for markets when things must get done?

Doll: I agree with that. I think (gridlock) is priced in. The market is expecting nothing next year. The expectation is things will get done in 2013 after the election.

Warne: Right now you have payroll tax cuts that expire at the end of this year. Everybody thinks those will be extended because nobody can think of any politician that wants to raise taxes on individuals in the beginning of an election year. But the Bush tax cuts expire at the end of 2012. So the impact is much more of a headwind in 2013.

I think we see more gridlock. But it doesn't actually change anything, because they have all put the deadlines off until after the election. But it is not a tailwind if nothing is done. The economy can keep going as long as we don't see the payroll taxes increase at the beginning of the year.

Bernstein: Whenever they decide to deal with the deficit, that will be a headwind. There is no way that either raising taxes or cutting spending is stimulative.

Q: So maybe gridlock is good after all?

Bernstein: One political reporter actually argues that politics next year will be a strong tailwind. His reasoning: Everybody will want to get re-elected, and we will see taxes go down and spending go up next year. One of the worst ways to get yourself re-elected is to tell people that they can't have stuff.

Q: So that would be the bullish Washington scenario?

Bernstein: Yes, because what it says is, you are going to get more stimulus, regardless of whether you are on the right or the left.

Q: But that strategy, while politically beneficial, might add to our deficit woes.

Miletti: Europe should be a looking glass for the U.S. We have to be careful about how much stimulus we put into the system and how much that creates more problems with the deficit. We have to be cautious about some of the fixes, and focus more on where we can add growth to the economy.

Q: How and when to slash the nation's deficit is a hot political issue. How will the issue affect markets?

Miletti: There has been very little focus on the fact that we actually need growth in this country to help us out in the long run.

The regulatory environment is going to be key. We have to be very careful in this country how much more controls we want to put on our economy, because that in turn is going to stifle growth and hurt us more in the long run.

Doll: The regulatory and tax reform are huge issues.

Lee: If you look at 2011, we did probably have one of the biggest political crises of our generation, and the economy actually accelerated. It really speaks to the underlying strength of the U.S. economy.

Kate Warne

Chief investment strategist, Edward Jones

Buy

PepsiCo (PEP, Thursday close: $64.85). Soft-drink and snack maker is "defensive play" with a plump dividend yield of 3.2% and reasonable valuation. It should sell more snacks if commodity prices remain weak.

Johnson & Johnson (JNJ, $64). Health care giant has "geographic and product diversity" and is positioned to profit via consumer, pharmaceutical and medical device businesses.

Intel (INTC, $23.31). Chipmaker moving beyond PCs to "faster- growing mobile phone space" and has sizable 3.6% dividend yield and a below-market P-E ratio of around 10.

Suncor Energy (SU, $26.61). Largest energy producer in Canada's oil sands has very good cost structure, production upside and is cheap vs. earnings.

Johnson Controls (JCI, $28.85). Auto parts supplier -- one of every three cars uses their components -- to benefit from "pent-up demand."

Warne owns none of the stocks; family member owns JNJ, SU.

Bob Doll

Chief equity strategist, **BlackRock**

Buy

UnitedHealth (symbol: UNH, Thursday close: $48.52). USA's largest HMO has 70 million customers and is growing. Stock buybacks using free cash flow to drive 10%-plus profit growth.

Dell (DELL, $15.05). Offers "good risk/reward" despite challenged PC business. Stock is "cheap and expectations are low," so shares could rise if Dell can "string together two good quarters of earnings back to back."

HollyFrontier (HFC, $21.93). Refinery is "cheap and more unloved" than most rivals and, despite narrowing refiner spreads, its better margins make it a good long-term story.

Philip Morris (PM, $75.92). Cigarette maker has strong free cash flow, pricing power, a yield of roughly 4% plus dividend growth. Share buybacks a plus.

Raytheon (RTN, $45.38). Large defense contractor has "less exposure to big-ticket items in defense budget" and more recurring revenue than competitors.

BlackRock owns all stocks; Doll and family own none.

Last Friday, Wall Street reporter Adam Shell sat down with six top investment strategists and portfolio managers in New York City for USA TODAY's 16th annual "Investment Roundtable." In a free- wheeling question-and-answer session lasting more than two hours, the panelists offered their investment outlooks for 2012 and shared their best moneymaking tips.

Richard Bernstein

CEO and chief investment officer, Richard Bernstein Advisors

Buy

U.S. assets. "The U.S., at worst, is going to be the best house on a bad block; people are underestimating risks in other parts of the world."

U.S. Treasury bonds. Despite low yields, Treasuries offer "diversification," as they've been the only major asset class whose price has been moving in the opposite direction of stocks and most other assets.

Small U.S. stocks. A play on domestic recovery; buy small-caps, especially financials and industrials, that will benefit from a better U.S. economy and avoid trouble abroad.

Dividend-paying stocks. "It's not original" and defensive plays are "expensive," but that "doesn't mean they can't get more expensive" given investor "risk aversion."

Avoid "credit-sensitive" plays. Investments tied to borrowing and leverage, such as housing, commodities, emerging markets, big banks and hedge funds, are likely to underperform.

Dan Chung

CEO and chief investment officer, Fred Alger Management (Alger Funds)

Buy

Apple Computer (symbol: AAPL, Thursday close: $378.94). "Strategic road map" for iPad and iPhone maker left behind by late CEO Steve Jobs will spur new management to "prove they can continue success."

Lowe's (LOW, $24.66). Home-improvement retailer is "bound to benefit from even a modest uptick" in the large, beaten-down housing market.

OpenTable (OPEN, $38.76). Once-high-P-E e-commerce play now "offers striking value," given its 25% growth rate and consumer following; also a possible takeover target.

Qualcomm (QCOM, $52.55). Leading chipmaker is in "excellent position" to profit from the "next generation of faster-speed wireless mobile networks."

Life Technologies (LIFE, $38.39). Provider of life sciences equipment and products has global portfolio positioned to profit from growing health care system and to rebound from 30% stock drop off its 52-week high.

Chung owns all via Alger funds; family owns AAPL, LOW, OPEN.

Tom Lee

Chief U.S. equity strategist, JPMorgan Chase

Buy

Stocks benefiting from housing recovery. Vacancies and mortgage delinquencies are at levels not seen since 2006 and 2008, respectively, and affordability vs. renting's the best in 20 years. If housing picks up, anything that supplies it will prosper, especially financial and consumer discretionary names.

Companies buying back shares. Buybacks have gotten so big that the share count in the S&P is shrinking, with the number of shares for sale back to 2000 levels. JPMorgan research shows the top 20 stocks in terms of buybacks beat the market by 20 percentage points since 2006.

Stocks that were winners in 2009. "Treat 2012 as a post- financial crisis year. The template is 2009." If Europe's crisis stabilizes, financial and consumer discretionary stocks could soar.

Beaten-down financials. Banks and other financials were the worst- performing group in 2011, but "there are reasons to own them today." They are "hugely levered to turns in housing." The No. 1 group since 1970 when housing turns is financials.

Ann Miletti

Senior portfolio manager, core equity, Wells Fargo Advantage Funds

Buy

Comcast (CMCSK, Thursday close: $23.07). Cable provider with "powerful pipe" for media and high-speed data will "pick up some growth" if housing market firms.

ON Semiconductor (ONNN, $7.18). Selling at roughly 50% of its private market value after being hurt by Japan tsunami and floods in Thailand.

Hertz (HTZ, $10.67). Rental-car company with strong brand is revving up on higher rental volumes compared with air travel and its push into market for longer-term rentals.

Grand Canyon Education (LOPE, $14.50). For-profit online educator with Arizona campus and strong management is gaining students and credibility.

Health Management Associates (HMA, $7.12). Concerns about health care reform have pushed stock near historic low multiples. Skilled management adds value by focusing on patient care and innovation. Acquisitions also spurring growth.

Miletti owns the stocks through Wells Fargo funds.

1. Buy U.S. assets. "The U.S., at worst, is going to be the best house on a bad block; at best it could be a shining star," says Richard Bernstein.

2. Avoid U.S. Treasury bonds. "They won't outperform again in 2012," says Dan Chung. "You'd have to believe that rates are going to continue to fall, and that stocks get shunned in a significant way."

3. Buy airline stocks. "A lot of people say you never can make money on the airlines," says Ann Miletti. But consolidation and shrinking seat capacity mean planes are full and ticket prices are going up. The wild card is fuel prices. If jet fuel doesn't spike, airline stocks can do well.

4. Buy stocks. "Equities are unloved, and they are underowned," says Bob Doll. Often, investments hated the most perform the best.

5. Buy dividend-payers with a history of boosting payouts. "We are not looking for the highest yielders," says Kate Warne. "We are focused on stocks with a track record of increasing dividends, rather than just those that pay dividends."

6. Seek out stocks benefiting from a housing pickup. "If housing picks up," says Tom Lee, "anything that supplies the housing market will prosper, especially financial and consumer discretionary stocks." Adds Lee: "Vacancies and mortgage delinquencies are at levels not seen since 2006 and 2008, respectively. And affordability vs. renting is at 20-year highs."

7. Buy U.S. small-company stocks. These volatile and economically sensitive stocks will work well and outperform if the dreaded "double dip" recession doesn't occur, Bernstein says.

8. Gobble up growth stocks. Search for companies that can deliver "growth, growth and growth" in a slow-growth economy, Chung says. The "best opportunities" will be in companies with "market leadership and pricing power" that can grow their revenues, earnings and cash flow in tough times.

9. Bet on domestic energy. Miletti is a "big believer in natural gas," an energy asset "right underneath our feet in the U.S." She believes the U.S. can "go from a country of importing energy to one that actually exports energy over time." Less restrictive regulations should allow for more drilling. That will "bring jobs and growth back to our country and provide more long-term security" as we become less dependent on foreign energy sources.

10. Buy stocks with profits earned domestically. "I believe in the U.S.," Doll says. "The U.S. is the only economy of size that has accelerated in the second half of the year, compared to the first half. There are more earnings benefits to come from that."

11. Go for global companies with exposure beyond Europe. "Even if more bad news comes out of Europe," Warne says, "companies that operate globally have a pretty good track record of finding areas of growth and benefiting from it."

12. Try stocks that soared in 2009. "Treat 2012 like a post- financial crisis year," Lee says. "The template is 2009. If Europe stabilizes, financial and consumer discretionary stocks will be winners like they were after the last crisis."

For months, U.S. stocks have been driven up and down by headlines out of Europe. One day stocks soar on hopes that eurozone policymakers have finally hatched a viable plan to solve its debt crisis -- only to plunge the next day on gloomy news about the ongoing risk of financial contagion or the European Central Bank's refusal to act as the lender of last resort for European countries in need of capital.

Q: Will U.S. markets be held hostage by Europe again in 2012?

Chung: If you look at U.S. corporate fundamentals and the direct exposure to Europe and the knock-down effect from the emerging- markets exposure, this is going to put a crimp in the profit growth potential for many companies next year. But a good amount of that is already priced into many stocks.

Q: How do you see the Europe crisis playing out?

Chung: I see two scenarios. Scenario A is a market riot (or big sell-off in stocks, bonds and other assets) that forces European politicians to act. Scenario B is European policymakers and banking regulators getting ahead of the markets and doing something good and, therefore, markets don't riot. Oddly enough, both of those scenarios pretty much end up in a better year for European stocks and U.S. and global equities.

Q: Would a really bad outcome in Europe -- say a really bad recession or serious credit crisis -- cause a market decline like we saw in 2008?

Warne: If we get a worst-case scenario in Europe and the markets riot, we don't see as bad a reaction as we saw in 2008. You can use the analogy of the sequel never being as good as the original movie.

Companies, individuals and banks in the U.S. are all in a much better position than they were three years ago. Everybody is sitting on a lot more cash. As a result, (any financial market turbulence) happens faster and is less dramatic because everybody is hunkered down."

Doll: That is part of why the market is selling at just 12 times earnings. Back to Dan's point: If that happens, the authorities' backs will be to the wall and then they will do something.

Q: What if Europe just muddles through its problems?

Warne: We could end up with more of the same, because the European leaders never do as much as they need to do, but they always do enough to calm things down short term. And everybody thinks this will go away, and it doesn't.

Lee: I think what will happen is the core countries of Europe, such as Italy and Spain, come under attack. And the next stage is you will have a bank run, and that is going to force the hand of the European Central Bank (to respond more aggressively).

Doll: Perspective is important. We are in a post-credit-bubble- bust world. That means all kinds of folks and institutions have to delever by reducing debt. The consequence of that is below-normal economic growth, which means there are going to be accidents from time to time. Every once in a while somebody will not be able to make their payment and you will have a little crisis.

Q: What will those little crises mean for investors?

Doll: To put it in black and white: If it is just Europe has a recession, and we continue to muddle through on the credit stuff, the U.S. can be fine. We don't do that much business with Europe. The risk is if there is an accident -- because the authorities in Europe stay behind the problem -- and eventually a bank has to declare bankruptcy, and the system just comes to a stop.

Q: So basically a big bank failure would be bearish?

Doll: Yes. And so I think there are two risks. One we can deal with; the other is a little more serious. There is a 10% to 20% chance that a bank fails, or the financial system just doesn't operate well enough and the credit market just comes unglued one more time.

Q: Are investors too complacent in thinking Europe will muddle through and avoid a bad outcome?

Miletti: Individual investors are a little bit more disconnected from it relative to all of us professionals in the room. That is what is causing them to stay away from stocks. They don't understand it.

Q: Do you think that being too fearful is the wrong strategy?

Miletti: I do. There are certain segments of the market that are getting (affected) by Europe, such as financial and industrial companies. Those are the two sectors that we are analyzing for our portfolios. What will be the impact of a slowdown in Europe on the rest of the world economy? So, I don't think there is complacency.

Bernstein: Europe is a symptom of a bigger issue: the deflation of the global credit bubble. People have believed for way too long that the credit bubble was a U.S. event.

We are now finding out that Europe was part of that global credit bubble. The next shoe to fall will be the emerging markets. They were the biggest beneficiaries of the global credit bubble, and people don't realize that. That is going to be the big story in 2012 and 2013.

But you can still make money. The U.S. will be the shining star, maybe the best house on a bad block. But Europe is just one in a series (of credit crises) that we are going to see, and people should be prepared for that.

Q: Fears of another severe slowdown have risen amid fears that Europe's debt crisis will cause a recession there and drag down the rest of the world. Will the markets next year be driven by recession worries?

Warne: We see more slow sluggish growth in 2012. We do not think that a recession is in the cards, unless you get a tax increase or an oil shock or something else. You need a shock to put the economy into a recession. The U.S. has less austerity than anybody. In Europe you have all these austerity programs. The U.S. said, "Not for us." I think that creates in 2012 a pretty good year.

Q: What kind of growth rate can we expect?

Warne: Over the last couple of months, basically all of the economic indicators have come in above expectations. You don't see runs like that forever. At some point in 2012, we will get another worry about a recession coming.

But 2012 basically is another year of 2% to 3% growth overall, but bumpy along the way because the economies around the world are growing slowly with headwinds of all sorts, ranging from de-leveraging consumers and everybody being cautious about all of the worries from Europe.

Doll: Growth this year for the four quarters was 0%, 1%, 2%, 3%. And I don't think we extrapolate 4%, 5%, 6%, 7%. Wouldn't that be nice?

Economies do not grow in straight lines; recoveries are very uneven. If we average 2% growth again next year, you will have a 3% quarter somewhere in there and there will probably be a 1% quarter, which means we may have a recession scare again next year. When and how it happens, I don't know. We are still in this deleveraging world, where there are some constraints to growth, and 2% growth is not a bad number.

Q: Is there going to be enough economic growth to allow companies to grow profits?

Chung: We kind of like the setup for corporate profits, margins and earnings next year. The efficiency of supply chains through technology and globalization ... allows companies to be leaner.

Q: Anything else make you bullish?

Chung: There are three major positives related to U.S.-oriented industries. Housing is still flat on its back in the U.S., but it is beginning to clear in some of the proprietary surveys that we do. We are not looking for a rocketing housing market, but even a marginal recovery is much less of a headwind and a big boost to economic growth.

Q: What are the other two potential drivers?

Chung: The auto industry. The fleet of cars is aging at a significant rate since the financial crisis, and that, too, will start to turn. There are some interesting things going on in the auto industry: the 35-miles-per-gallon mandate and alternative hybrid vehicles -- and companies are adjusting. That will be a big boost if the auto industry starts to come back. Finally, there is some of the dislocation caused by really weird weather, and the Japanese tsunami.

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MONEY
Does S&P 500 cherry-pick popular stocks?

Matt Krantz
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Q: Does Standard & Poor's tend to add hot stocks to the S&P 500 index, rather than sleepers?

A: It's widely believed that when stocks get added to major stock market indexes, it's because they've been top performers and their days as great stocks are over.

And there's been some truth to that statement.

First consider the Dow Jones industrial average.

Two of the four stocks most recently added to the Dow have been very poor performers subsequently, according to Dow Jones and S&P Capital IQ. Consider some examples:

Bank of America has dropped 85% since being added to the Dow on Feb. 19, 2008.

Cisco Systems is down 9% since June 8, 2009.

Kraft is up 6% since Sept. 22, 2008.

Travelers has risen 32% since June 8, 2009.

The idea that stocks tend to languish after being added to the Dow isn't all that surprising.

After all, the index is supposed to be a collection of the 30 most-established and widely recognizable companies.

These aren't, by definition, going to be the stocks that set the stock market on fire.

But what about the Standard & Poor's 500?

Specifically, you are asking whether the company that maintains the S&P 500, S&P Capital IQ, tends to replace stocks that might be lagging with those that are the new darlings among investors.

Checking in with recent additions

To find out, here's an examination of stocks that were added to the S&P 500 this year and how they'd done in the two years prior to being added, according to Standard & Poor'sCapital IQ:

Mosaic: Up 24% two years prior to Sept. 21.

Accenture: Up 86% two years prior to July 5.

Alpha Natural Resources: Up 80% two years prior to June 1.

Chipotle Mexican Grill: Up 271% two years prior to April 20.

BlackRock: Up 55% two years prior to April 1.

Edwards Lifesciences: Up 187% two years prior to March 31.

Covidien: Up 29% two years prior to Jan. 26.

Noble: Up 81% two years prior to Jan. 14.

Looks like your hunch is correct: S&P, at least this year, has been adding winners to the S&P 500 index.

Every one of the added stocks had gained over the two years prior to their addition and, in many cases, by a large amount.

But before you assume that these changes somehow distort the index, keep in mind that these changes are somewhat done by design.

Remember that the role of the S&P 500 is to reflect the value of the stock market.

Stocks that are gaining market value are bigger contributors to the stock market and, therefore, deserve to be a bigger part of the index.

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MONEY
Double-dip odds on the rise ; And contradictory economic reports increase uncertainty

Scott Patterson
Scott Patterson, USA TODAY
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Is the economy heading toward a double-dip recession?

Economists say it's difficult to tell whether a second recession is on the way, so soon after the last one officially turned into a weak recovery two years ago. For every sign pointing to a slowdown, another indicates a pickup.

Recent economic reports have shown weakness in everything from manufacturing to consumer spending. The government recently revised its estimate of gross domestic product growth for the first quarter down to a meager annual rate of 0.4%. In the second quarter, the GDP growth rate was just 1.3%.

Other indicators, such as corporate earnings, are at their strongest levels in years.

Thursday's 513-point plunge by the Dow Jones industrial average, its largest decline since late 2008, sparked concerns that the economy is heading off a cliff, because stocks are often seen as an indicator of future growth.

Signs of economic weakness, the game of chicken with the U.S. debt ceiling that played out in Washington, D.C., and the spreading debt crisis in Europe have unnerved investors. Standard & Poor's downgrading of the U.S.' credit rating, announced late Friday, may heighten worries when markets open today.

But Friday's employment report, which showed that the economy added a better-than-expected 117,000 jobs in July, helped ease concerns that another recession is around the corner. In response, the Dow posted a mild gain. In keeping with the mixed signals investors are getting, other indexes, such as the Nasdaq composite, declined.

Tuesday, the Federal Reserve's policy committee will meet in Washington to determine how to respond to the latest twists and turns in the economy. Few expect the central bank to announce new plans to stimulate growth, but investors will keep a keen eye out for any hints that such plans are under consideration.

There's little question that the odds that the economy is heading toward a contraction are on the rise. John Lonski, chief economist at Moody's Investors Service in New York, put the chance of a recession at 40%, up from just 20% a month ago.

His reason: the steep decline in the stock market, which can hurt consumer spending. In the recovery from the 18-month recession that ended in June 2009, rising stock prices have helped make consumers feel better off, even as many saw the prices of their homes decline.

Now, home prices remain in a ditch and stocks are taking a beating.

"What the U.S. can ill afford is the decline in equity prices in view of how home prices have continued to fall," says Lonski. "It will reduce household wealth."

The debt troubles in Europe are also a major concern for the U.S., because a collapse in Europe would hurt demand for U.S. goods and wreak collateral damage on the financial sector, which holds a substantial amount of European government and corporate bonds.

The last time the U.S. economy experienced a double-dip recession was in the early 1980s, when high inflation and interest rates sapped corporate profits and emptied consumer pocketbooks. Starting in early 1983, the economy came roaring back, sparking a powerful bull market in stocks that didn't stop until the dot-com bust of 2000 and 2001.

The time period between the early-1980s recessions was 12 months, according to the National Bureau of Economic Research, which tracks recessions. Since the most recent recession officially ended more than two years ago, in June 2009, economists may quibble over whether another downturn qualifies as a technical "double dip." For many Americans, however, it seems as if the recession has never ended -- which is why some have dubbed the period the Great Recession.

Another difference this time: A sharp, steady decline in interest rates beginning in the 1980s drove the post-double-dip recovery. Today, however, interest rates are already at record lows. That poses the question: What could pull the economy out of a recession this time?

Government spending seems tapped out, as the latest debate over the debt ceiling in Washington, D.C., showed. The Federal Reserve fired a massive amount of ammunition at the recession, going to extraordinary lengths to spur growth. While the central bank may still have a few tricks up its sleeve, skeptics say they won't be enough to pull the economy out of a steep slowdown.

Recent signals "show an economy with very weak growth prospects," IHS chief economist Nigel Gault wrote in a note Friday. "It is ... disturbing that policymakers do not seem to have the weapons to match the risks we are facing."

Of course, if the Fed picks up a whiff of deflation -- a steady decline in core consumer prices -- there's little question that it will throw the kitchen sink at it. Concerns about deflation were behind the Fed's stimulus moves in 2009 and 2010.

Deflation can devastate an economy, because consumers often stop spending, expecting prices to decline further. In the 1930s, a prolonged period of deflation triggered years of economic chaos.

Not everyone agrees that the economy is sputtering, of course. Bob Doll, chief equity strategist at **BlackRock**, pointed out in a Friday report that gasoline prices are declining and banks are starting to lend more to small businesses. And the temporary impact of the earthquake and tsunami in Japan on the global supply chain is easing.

"For all these reasons," he wrote, "we do not believe the United States will be entering a recession anytime soon."

A month ago, Wrightson ICAP chief economist Lou Crandall was optimistic that the economy was on a path toward solid growth in the second half of the year. Now, he says, he's become more concerned, in part because of a negative shift in sentiment. If corporate managers fear that the economy is slowing, they'll cut back on capital expenditures and put off hiring.

While he remains "cautiously optimistic," he says, "we're back in a period of maximum uncertainty."

Lonski at Moody's points out that while growth could pick up, another unforeseen shock, such as a renewed surge in oil prices, could be enough to push the economy over the edge.

Perhaps the weakest corner of the economy is job growth. Friday's jobs report showed that while the unemployment rate in July ticked down to 9.1% from 9.2% in June, a big factor was that more workers have essentially given up looking for a job. The so-called labor force participation rate -- the number of workers actively looking for a job -- fell to 63.9% from 64.1% in June.

Economists certainly weren't hailing Friday's jobs report as an all-clear signal. "While July's employment report provides a drop of decent news amidst a downpour of depressing data, it does little to change our fundamental thesis of long-lasting economic sluggishness," wrote Guy LeBas, a fixed-income strategist at Janney Montgomery Scott, in a note.

According to some metrics, the high unemployment rate indicates that the economy is perched dangerously close to a recession. A recent report by Goldman Sachs economist Andrew Tilton showed that, according to historical trends, if the unemployment rate ticks up a mere 0.2 or 0.3 percentage points in the next two or three months, the odds will increase sharply that the economy is either in a recession or will be in one soon.

The reason, Tilton argues, is that employment is critical to economic strength because of those crucial self-reinforcing feedback effects.

"When economic activity slows enough to push the unemployment rate higher for more than a short period, household income growth is interrupted," he wrote in a report. "This typically leads to a pullback in consumer spending, and companies respond with further cuts in labor demand."

Perhaps the best argument against the double-dip scenario is a continuing boom in corporate profits. According to Goldman Sachs, 46% of the companies in the Standard & Poor's 500-stock index have reported better-than-expected earnings results for the second quarter. Earnings are on pace to grow 15% from a year ago.

With more money to spend, companies have the ability to hire more workers. To do so, however, they need to anticipate growing demand. Right now, that's not the case. The Conference Board's measure of the confidence of chief executive officers fell sharply in the second quarter. Only 33% of CEOs surveyed said conditions improved in the quarter from six months ago, compared with 85% in the first quarter.

Confidence can easily shift upward again if the economy starts to show signs of life. If it does, all that cash sitting on corporate balance sheets could be unleashed, driving the economy toward a sustained recovery.

"This is really a crisis of confidence," says Moody's Analytics chief economist Mark Zandi. "Confidence was completely pummeled because of the debt crisis spectacle. But eventually, businesses will know they need to take a chance, just like they have in every business cycle since World War II."

The ups and downs of recent U.S. recessions

Recessions typically occur at least several years apart. Some economists call the 1980-82 recessions a "double dip" because the second started only a year after the 1980 recession ended. When the six most recent recessions began and ended and the gap between recessions:

Recession

Length

Nov. 1973-March 1975

16 months

4 years, 10 months

Jan. 1980-July 1980

6 months

1 year

July 1981-Nov. 1982

16 months

7 years, 8 months

July 1990-March 1991

8 months

10 years

March 2001-Nov. 2001

8 months

6 years, 1 month

Dec. 2007-June 2009

18 months

Source: The National Bureau of Economic Research

GRAPHIC, Color, Sam Ward, USA TODAY (Illustration); PHOTO, Color, Paul Sancya, AP

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MONEY
Red tide rising ; Money managers grow wary as debt-ceiling impasse drags on

Scott Patterson
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In June, portfolio managers at **BlackRock**, one of the world's largest fixed-income fund companies, met in the firm's Midtown Manhattan headquarters to discuss what would happen if the U.S. government failed to raise the debt ceiling by Aug. 2.

The consensus in the room was that such a possibility was extremely remote. Still, the managers started to sketch out game plans in case the unthinkable occurred. They agreed that if substantial progress hadn't been made by Congress and the Obama administration by mid-July, they'd have to take the issue more seriously.

That time has come. Turmoil in financial markets is sure to increase as the deadline nears, making it harder for a giant firm like **BlackRock** to make big shifts in its portfolios. Each day, the government inches closer to what most market watchers say would be a severe shock to the financial system.

While plans such as the so-called Gang of Six deal to slash the deficit by an estimated $3.7 trillion in 10 years briefly sparked hopes that a deal was on the table, optimism quickly faded amid fierce partisan bickering over the details. Wednesday, President Obama signaled that he's prepared to accept a short-term agreement to boost the ceiling under certain conditions, a move he'd long opposed.

The problem in a nutshell: On Aug. 2, the federal government will no longer legally be able to increase its debt to fund spending, according to the Treasury Department. Without an agreement to raise the ceiling, the government will have to fund programs with incoming revenues such as taxes. Trouble is, a lot more cash is flowing out than is flowing in -- which is at the heart of the crisis.

Roughly 40% to 45% of federal government bills will go unpaid almost immediately because of the gap between revenues and expenses. The government will favor payments on Treasuries to stave off a default.

The pain will come hard and fast. On Aug. 3, the government will have about $12 billion in revenues flowing into its coffers, and $32 billion in spending commitments, including $23 billion in Social Security payments, according to the Bipartisan Policy Center. Decision makers at the Treasury Department will have to quickly decide how to spend the available cash. About $20 billion in spending will have to be put on hold.

The chaos will almost certainly trigger panic in financial markets.

BlackRock has already made moves to protect its actively managed portfolios, reducing its exposure to risky, high-yield corporate bonds and private-sector mortgages. It has increased its holdings of safe-haven assets such as high-quality corporate bonds and government-backed mortgage bonds. Concerns about the debt situation in Europe also prompted its moves into safer corners of the market.

"We still think default is remote, but we have improved the quality and liquidity of our portfolio," says Rick Rieder, chief investment officer of **BlackRock**'s actively managed fixed-income portfolios, which include $595 billion in assets.

BlackRock has plenty of company. Money managers across Wall Street are starting to discuss in private meetings what to do in case the U.S. government fails to raise the $14.3 trillion cap on its borrowing capacity by early August. Most think Congress will reach a solution before the deadline, but concerns surged in the past week amid heated wrangling between political parties over terms of a deal.

"It does seem like this is going down to the wire as politicians" exchange barbs, says Kathleen Gaffney, co-manager of the $20 billion Loomis Sayles bond fund in Boston.

Last Wednesday, the Standard & Poor's six-person investment policy committee met in a conference room in the firm's New York office. The weekly discussion focused on the debt-ceiling debate.

Sam Stovall, S&P's chief investment strategist, opined that it was highly unlikely that Congress would fail to act in time. "The consequences of not raising the debt ceiling are so severe that congressional bickering makes for high drama but low risk," he says he told the committee.

Still, S&P mapped out a likely scenario for the market if Aug. 2 passed without an agreement. Treasuries will tumble, sending interest rates higher. The value of the dollar will fall. And precious metals such as gold will surge. As for stocks, they will get pummeled. Investors would be wise to gravitate toward stocks that traditionally hold up in bear markets, such as large-cap value and health care stocks, the committee agreed. Technology and financial stocks would likely be among the worst performers.

The government's failure to act well in advance of the deadline could also result in market turmoil, investment managers say.

The longer it takes for the government to solve the issue, the more volatility will hit the bond market because of uncertainty about a solution. The volatility could spill into stocks and ultimately ripple into the broader economy.

A rising stock market has been a rare boost to consumer pocketbooks in recent months. If stocks sink, consumers are likely to pull back even more, draining more cash from the economy.

Forecasters had expected the economy to rebound in the second half of the year after a second-quarter soft patch. If the debt- ceiling wrangling continues much longer and financial markets grow jittery, the recovery could be at risk.

Managers are at odds over how Treasuries will respond if the deadline is reached without a compromise. Some say Treasury bonds could rally as investors pile into what is typically perceived as the safest asset in the world.

During times of turmoil, risk-averse investors usually pour money into Treasury bonds, which have a high "liquidity" premium, meaning they are very easy to buy and sell. Jittery investors tend to gravitate toward liquid assets in case they need to make quick moves.

The difference this time: The turmoil is coming from the Treasury market itself.

Robert Kessler, chief executive of Kessler Investment Advisors, a Denver manager of Treasury securities, believes investors will rush into Treasuries in the event of a debt-ceiling crisis. While acknowledging that the epicenter of the crisis will come from U.S. debt, he says investors seeking a haven will have little choice.

"Is there an alternative?" he asks.

Moreover, any significant shock is likely to damage an already shaky recovery, Kessler says. That will keep a lid on inflation, which helps Treasuries. If the government enacts big spending cuts, that could further dent the recovery as cash is sucked from the economy.

In the past few months, Kessler has been increasing his firm's exposure to Treasuries. "I can't think of a reason why I wouldn't increase" my Treasury purchases, he says. He says he plans to continue buying even if Aug. 2 slips by without an agreement.

Caution on Treasuries

One firm that has been bearish on Treasuries is Pimco, the world's largest fixed-income fund manager. Pimco investment guru Bill Gross has been negative on Treasuries for much of the year, arguing that inflation is a risk and that better deals can be found overseas. While Pimco's $243 billion Total Return fund boosted its holdings of Treasury securities to 8% in June from 5% in May, the firm's outlook on Treasuries remains negative.

Federal Reserve Chairman Ben Bernanke, in testimony before Congress last week, said a default would trigger "a major crisis because the Treasury security is viewed as the safest and most secure security in the world." Take away the Treasury bond's reputation for safety and security, and the results could be catastrophic.

"The notion that it would suddenly become unreliable and illiquid would throw shockwaves throughout the global financial system," Bernanke said.

Experts say that even a short-term crisis could lead to a permanent stain on Treasuries. It could prove particularly damaging to the willingness of foreign investors to buy Treasuries.

China, the U.S. government's largest creditor, held about $1.16 trillion in Treasury securities as of May. At a briefing last week, Chinese Foreign Ministry spokesman Hong Lei said China hopes "the U.S. government adopts responsible policies to protect the interests of investors."

If foreign investors start to shy away from Treasuries, they will become much less liquid.

"You could never get that liquidity premium back if you create a precedent," says Lou Crandall, chief economist at Wrightson ICAP. "That's the thing that would be irreparable."

The end result of such a scenario: higher interest rates in the U.S.

Thomas Gallagher, a political economist at the Scowcroft Group, a Washington, D.C., advisory firm, has mapped out a variety of possible market reactions to the debt-ceiling crisis and the budget negotiations. The most vulnerable asset class as the Aug. 2 deadline nears: stocks. Stocks are widely perceived as riskier than bonds and tend to be more susceptible to market shocks.

"The closer we get to Aug. 2, (the more investors) will leave risky assets and go into safer assets," he said. "This will be the dominant effect."

The Treasury Department will also be scrambling to roll over nearly $500 billion in debt that matures in August. Typically, this is simply done by issuing new bonds to replace the more seasoned bonds. But if there is a disruption in the market, buyers may not materialize. Interest rates may go up in order to lure more buyers. In the worst case, there won't be enough buyers for the new debt.

Rating agencies' influence

The situation is likely to be worsened by rating agency actions. Already, Standard & Poor's, Moody's Investors Service and Fitch Ratings, the three biggest U.S. rating agencies, have warned that U.S. government debt could be downgraded -- an unprecedented event - - from its sterling triple-A status if the debt ceiling isn't raised by Aug. 2.

S&P recently said there was a 50% chance that it would downgrade the United States' rating in the next three months, citing the government's apparent inability to solve its fiscal troubles.

If all three rating agencies downgrade the U.S., that could force money-market funds to dump Treasury holdings. The funds, which as a rule invest only in safe assets, often require at least one agency to rate the assets they hold triple-A.

As of July 12, of the $2.4 trillion in all taxable U.S. money market funds, about $400 billion is in Treasuries, according to iMoneyNet, which tracks money market fund holdings.

The forced selling could trigger turmoil across financial markets, causing interest rates to shoot higher. It could also freeze up assets in the money market fund industry, a systemic shock like what briefly occurred after the collapse of Lehman Bros. in 2008.

Berkshire Hathaway Chairman Warren Buffett has said the turmoil in money market funds after Lehman's collapse was the closest the U.S. financial system came during the crisis to a catastrophic meltdown.

GRAPHIC, Color, Sam Ward, USA TODAY (Illustration); GRAPHIC, Color,
Kris Kinkade, USA TODAY (bar graph)

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MONEY

IN THE DEBT-CEILING DEBATE, IS FAILURE NOW AN OPTION?

John Waggoner
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Every night - sometimes late into the night - worried men and women are talking about how to handle their debts. Those people would be your members of Congress. If Congress doesn't raise the debt ceiling by Aug. 2, the United States could default on its debt for the first time in history, according to the Treasury.

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The debate about raising the debt limit which has been increased nearly 100 times including its most recent jump in February has been exceptionally shrill.

Lost in the debate have been several key facts. The U.S. debt, measured as a percentage of gross domestic product, isn't particularly out of line with most developed nations. The bond market, which should be most worried about the U.S. debt burden, doesn't seem concerned at all about the U.S. debt load.

Congress, which authorized the government's spending, shouldn't be the least bit surprised that the nation has reached its debt limit. But the biggest myth about the debt is that defaulting wouldn't be a problem. It would.

Shocked! Shocked!

Congress should be the last people surprised by hitting the debt ceiling. They passed the authorization to bust through it.

The debt ceiling statute was passed in 1917, and has been routinely raised by Democratic and Republican congresses. Because spending decisions reside with Congress, the debt limit has sometimes been deemed to increase automatically when Congress authorizes spending over the limit.

The nation officially hit the $14.3 trillion ceiling on May 16, but the Treasury, using various accounting tactics, has been able to keep government operating normally. Treasury Secretary Tim Geithner says his department will run out of tricks on Aug. 2, at which point the U.S. could default on its debts.

Congress, of course, was well aware of the debt ceiling when it passed its spending authorization on April 15, which legally mandated a 2011 deficit of about $1.7 trillion. (The federal fiscal year ends Sept. 30.) This hasn't stopped members of Congress from lamenting the feckless spending habits of Congress.

"For decades, Washington has blindly increased the debt limit while doing little to stop spending money that it doesn't have, a dangerous pattern that must end," Rep. Eric Cantor, R-Va., said on April 18. The continuing resolution to fund the government through the end of the fiscal year passed the House of Representatives on April 14 with a vote of 260 for the bill, 167 against, and six not voting. Cantor voted for the bill.

Voting against raising the debt ceiling hasn't been limited to prominent Republicans: Then-senator Barack Obama voted against raising the debt ceiling in 2006, when George W. Bush called for spending that would exceed the limit. Obama has since called that vote "a mistake."

How much?

The U.S. debt is vast, by all accounts. But the country is by no means broke.

The discussion about the deficit is intimidating because the numbers are so large. A billion seconds ago, Jimmy Carter was president, Pete Rose was playing for the Cincinnati Reds, and John Paul II became pope. A trillion seconds ago, wooly mammoths were roaming the Earth and man was just venturing out of the trees. A trillion seconds is about 32,000 years, vs. 32 years for a billion seconds.

The U.S. debt has two components: public debt and intragovernmental holdings.

The $9.7 trillion public debt is what the U.S. has borrowed through Treasury securities Treasury bills, notes and bonds.

The remaining $4.6 trillion is intragovernmental debt, primarily, the government securities held by the trust funds for Social Security and Medicare. The $4.6 trillion is largely an accounting fiction: The special government bonds used for the trust funds would be counted as identical assets and liabilities on a standard balance sheet. Both Medicare and Medicaid are essentially pay-as-you-go operations funded by payroll taxes.

Economists take the $9.7 trillion public debt more seriously than intragovernmental holdings. Congress can authorize cuts in Social Security and Medicare, but it can't renegotiate the terms of outstanding Treasury securities without defaulting.

While $9.7 trillion is still an enormous number, what makes a debt onerous is the borrower's ability to pay. By that measure, the U.S. is nowhere near a debt crisis. Last year, the public debt was about 58% of U.S. gross domestic product. The United Kingdom's was 79% of GDP, and Greece's was nearly 124%.

Even if Congress does nothing to trim spending this year which is unlikely government expenditures will fall next year as the federal stimulus program ends and people start to lose unemployment benefits, says Mark Zandi, economist for Moody's Analytics. And tax revenues will rise as the economy expands.

What crisis?

The biggest judge of the nation's debt problems is the bond market. Bond traders are lenders, and they're interested in two things: collecting their interest payments, and getting their money back when the bond matures. Any hint of default sends interest rates soaring, just as your credit card rate would rise if you suddenly showed signs of financial distress.

A recent example: When bond investors began to suspect that Greece would be unable to pay its debt, investors drove up the yield on Greek government bonds. The Greek 10-year government bond now yields about 16.5%, vs. 2.9% for German 10-year government bonds.

Are bond investors worried about U.S. debt? Apparently not. The U.S. 10-year note yields 3.17%. Half the U.S. debt is due in about five years, according to the Treasury. A five-year T-note yields 1.5% less than the current rate of inflation. Bond investors are not only not worried about default, they're not worried about losing the buying power of their money.

BlackRock, the largest publicly traded money manager, ranks the U.S. 15th-lowest among 44 countries for sovereign risk. The index includes the country's overall debt structure and willingness to pay. Top two countries: Norway and Sweden, which also have some of the most generous social programs. Worst: Portugal and Greece.

Investors trust the U.S. Treasury because it has never defaulted, and because the United States has vast resources at its command. The nation's gold reserves, for example, are worth nearly half a trillion dollars at the current price of gold. (Dumping that much gold would, of course, depress the price.) U.S. tax rates are low, compared with other developed nations. The maximum U.S. income tax rate is 35%, and government revenues are about 30% of GDP relatively low, according to **BlackRock**. In contrast, the maximum German income tax is 45%; wealthier Germans pay an additional 5.5% surtax.

Most of the U.S. debt is held by U.S. investors: individuals, banks and insurance companies. The largest foreign holder, China, owns about $1.1 trillion of U.S. Treasury securities, or about 11% of public debt.

A catastrophe

Some lawmakers have been floating the notion that hitting the debt ceiling doesn't have to mean default to bondholders. Sen. Pat Toomey, R-Pa., has raised the idea of requiring the Treasury to pay bondholders before anyone else. That would avoid a technical default and require massive budget cuts at the same time.

It's hard to argue, however, that bondholders won't be spooked by the government furloughing workers, shutting down parks or cutting services. If the government made its debt payments and paid Social Security and Medicaid, there would be precious little to pay for defense contractors, federal salaries and other normal functions of the government.

"The hope that we can breach the debt ceiling and nothing bad will happen is just plain wrong," says Zandi. Bonds wouldn't be the only investment affected: Stocks would likely crater, too, on fears of soaring unemployment and higher interest rates. Standard & Poor's said Tuesday that it would slash the U.S. top credit rating to "selective default" if it misses a debt payment.

Nothing quick or easy

While the debt isn't a crisis now, sooner or later the U.S. must take steps to reduce its chronic deficits. And it won't be easy, especially in a weak economy. Cutting jobs and raising taxes both harm the economy.

Paying the debt off entirely would require about $47,000 from each person in the U.S., or $1,572 a year if spread out over 30 years. (The Treasury takes donations, if you're especially concerned about the debt: So far this year, the government has accepted $1.8 million in gifts. Last year, it received $2.8 million.)

The best hope for the government is to keep debt from building up by reducing or eliminating annual deficits. Eventually, modest declines in debt, coupled with economic growth, would make the nation's debt-to-GDP ratio smaller. This was the approach taken by the U.S. after World War II, when the debt-to-GDP ratio was even larger. The Greatest Generation had higher taxes (a maximum 93%) and smaller government no Environmental Protection Agency and no Energy Department, among others.

Several countries have greatly improved their debt-to-GDP ratio by a mixture of tax increases and spending cuts. Sweden's gross debt- to-GDP ratio has fallen to 39.6% from 50.4% in 2005, according to the Organisation for Economic Co-operation and Development. The country cut spending and instituted reforms to boost the economy. The fact that it had a surplus heading into the downturn and a tiny military budget didn't hurt, either.

But what's required is a national discussion on how best to grapple with the debt and the perception that voters want politicians to do so. Zandi points to Canada, which has taken big steps toward reducing its debt. "Canadians couldn't find the will to make changes until the electorate got the perception that changes were needed," he says. "Public attitudes swung to 'If you don't cut benefits and raise taxes, we won't vote for you.'"

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MONEY
BofA to settle case for $8.5B ; Mortgage investors to get refund payout

Matt Krantz
Matt Krantz, USA TODAY
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30 June 2011
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Bank of America agreed to pay $8.5 billion to investors who bought troubled mortgages that ended up going bad, a significant step in the slow process of moving past the mortgage bust.

The settlement is being paid to 22 investors, including **BlackRock**, Pacific Investment Management and Goldman Sachs Asset Management, which bought mortgages Bank of America's Countrywide unit sold in the form of bonds.

Bank of America bought Countrywide in June 2008, just before the debt and mortgage markets unraveled amid falling housing prices and rising defaults.

Investors were relieved the settlement wasn't larger. Shares of BofA rose 32 cents, or 3.0%, to $11.14. The settlement amounted to 2 cents on every dollar lent on loans with an original principal balance of $424 billion, says Thomas Mitchell at Miller Tabak.

It isn't enough to force it to raise more money, says Marty Mosby of Guggenheim Securities. The bank has between $25 billion and $50 billion in excess capital based on the calculation used, he says.

Due to this settlement and other mortgage-related costs, the bank expects to post a loss of up to $9.1 billion in the second quarter . The company is also reserving another $5.5 billion in this quarter to cover possible additional settlements.

This settlement is a big start in making amends for the housing crash, but there's more to come. Other banks will likely need to settle with their investors, too, says David Trone of JMP Securities. Litigation about states' claims regarding improper foreclosure procedures are also still pending, he says. Remaining settlements per bank, though, will likely be lower than Bank of America's settlement with investors, says Bose George of Keefe Bruyette & Woods.

Possible settlements about allegations of improper foreclosures are estimated to be around $20 billion for the entire industry, George says.

Meanwhile, the housing market is still challenged with unsold homes and foreclosures, says Nancy Bush at SNL Financial. The settlement is part of the recovery, as it gives banks more of an idea of what their potential exposure to litigation could be, she says. But "we still have a long way to go," perhaps three to five years, Bush says, before "getting a housing market that looks anywhere near normal."

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MONEY

Inflation? Not with a 9% jobless rate ; Despite rising fuel and food costs, the economy is still too sluggish

John Waggoner
John Waggoner, USA TODAY
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English

If you want to see whether we're in for crushing, '70s-style inflation, take this simple test.

You walk into your boss's office and explain to him that the price of food and fuel are soaring, and that you'd like a raise. He:

A: Nods sympathetically and promises you'll see more cash in your paycheck at your next review.

B: Says, "If you can get a better-paying job elsewhere, go right ahead."

Rising food and energy prices do indeed put a dent in your budget. But if you're looking for inflation that parties like it's 1975, you need to have rising wages, and that's just not happening.

Instead, higher food and energy prices mean you'll have to cut back on your spending elsewhere which slows the economy and can drive other prices lower. Unless employment suddenly shoots up, or confidence in the dollar utterly collapses, the most likely outcome is stagflation a slow economy plagued by higher commodity prices.

A survey by the Pew Research Center in March showed that 28% of those polled ranked inflation as the most worrisome economic problem the nation faces, beating out the federal budget deficit (24%) and financing and the housing markets (10%). Only the job situation (34%) outranked inflation as the nation's biggest financial worry.

And inflation fears seem to be rising. The University of Michigan's Consumer Confidence Survey shows that inflation expectations are at their highest since June 2009.

But most data don't confirm those worries. Consider the consumer price index, the government's main gauge of inflation. Every month, the Bureau of Labor Statistics measures the prices of everything from eggs to autos. The CPI has risen just 2.9% in the 12 months ended in April.

Each item has a weight in the index. For the CPI that you normally read about in the newspaper, the so-called headline number, the weights are based on the spending of all urban consumers, who make up about 87% of the population, according to the BLS.

Your actual experience with inflation will probably vary wildly from the CPI. If you drive a lot, have kids in college or go to the doctor often, your personal inflation rate will be higher than the CPI. The same is true if food is a large part of your family's budget.

Feeling the volatility

Generally speaking, the lower your income, the more you feel higher food and energy prices, says Lisa Emsbo-Mattingly, director of asset allocation research for Fidelity Investments. Rising food prices, in fact, are a leading cause of political unrest in emerging markets, because food accounts for a far higher percentage of consumers' budgets than it does in the U.S.

Because food and energy prices are volatile, economists tend to look at the CPI without food and energy, figuring that real inflation increases when price jumps from, say, oil, work their way into more mundane objects, such as plastic soft drink bottles. They get a lot of grief for it.

"I was on a program awhile back, talking about inflation (excluding) food and energy," says Ken Goldstein, economist for The Conference Board. "I got an angry e-mail saying, 'Hey, dummy, what the hell do you think we spend our money on?' It was from my brother."

But the CPI doesn't appear to be that far off. Another method of tracking prices, the Billion Prices Project at the Massachusetts Institute of Technology, uses prices from online retailers worldwide to measure inflation. Using this method, prices have risen 3.5% in the past 12 months. The Billion Prices Project doesn't measure the cost of services, such as carpet cleaning, but it's more up to date than the CPI, which lags by a month.

As annoying as rising food and oil prices are, they're offset somewhat by falling prices in other areas, such as cellphones, computers and clothing, says Beth Ann Bovino, senior economist at Standard & Poor's. And while your housing expense doesn't increase when the value of your home falls, a lower home price lowers your net worth and reduces your inclination to spend.

But the main impact of rising food and oil prices is that it reduces demand for other goods. Normally, shortages of goods lead to higher prices, as factories fail to meet demand. But the nation's factories are running at 76.9% of capacity, vs. an average 80.4% from 1972 to 2010, according to the Federal Reserve. There are no shortages in sight.

Trouble ahead?

Inflation could increase in several ways. The first would be via a prolonged period of higher oil and commodity prices, both of which are beyond the Federal Reserve's power to ameliorate.

Consumer inflation expectations are highly correlated to the price of oil, and that's dangerous, because when people expect prices to rise, they change their behavior typically in ways that feed inflation. For example, in an economy where prices are rising, people tend to spend more rapidly, figuring that prices will be higher later. That increases demand. And when inflation fears are high, it makes sense to borrow to buy, and repay your debts with cheaper dollars.

When oil prices rise, as they did in 2009 and again earlier this year, people begin to fear that the prices of everything else will rise, as well. "The University of Michigan surveys are very indexed to prices at the pump," says Martin Hegarty, co-head of **BlackRock**'s global inflation-linked investment portfolios. After all, most people in the U.S. are reminded of higher prices every time they go to the gas pump.

But oil prices are "more of a problem for growth than a replay of the 1970s," says Mark Vitner, senior economist for Wells Fargo. In theory, as higher oil prices cause consumers to cut back on spending in other parts of their budget, the economy should slow, demand for oil should fall, and so should oil prices. And, in fact, the price for West Texas intermediate crude has fallen from a high of $113 a barrel to $100.74 now, reflecting lower demand and weaker economic growth.

Oddly, the weak housing market could indirectly increase inflation. As prices continue to tumble and banks tighten lending standards, more people are choosing to rent. But few new apartment buildings are being built, so rents on existing apartments are rising. Shelter accounts for about 40% of the CPI, says the Conference Board's Goldstein. "If indeed we see a pickup in rents, that will feed the perception that inflation is about to kick up," he says.

The big worry is whether the Federal Reserve's efforts to get the economy going will backfire and spark inflation. Essentially, the Fed has been trying to fight off the possibility of Depression- style deflation a period of falling prices by pumping money into the system. For example, its most recent round of quantitative easing involves buying Treasury securities with money created, essentially, out of thin air. The Fed's buying may have kept interest rates lower than they would be otherwise.

If the economy starts to take off, however, all that extra money sloshing around could lead to higher inflation, says Standard & Poor's Bovino. If the Fed is too slow to take excess money out of the system, the risk of inflation will rise sharply. But a stronger economy is "at least a year away," she says.

The more likely outcome, says Wells Fargo's Vitner, is a period of slow growth, made more painful by high food and energy prices stagflation, a term first coined to describe the British economy in the 1960s. Low income growth, higher prices and high unemployment is the most likely outcome, Vitner says.

"It's not a whole lot of fun."

GRAPHIC, Color, Alejandro Gonzalez, USA TODAY (Illustration)

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MONEY

In 2011, it's all about stocks ; 5 top experts agree: New year's looking great for stocks, not so great for bonds

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NEW YORK -- Five Wall Street heavyweights say it's time for individual investors to shun the perceived safety of bonds -- and get over their fear of the U.S. stock market -- so they can take advantage of what they predict will be a third straight year of solid gains for stocks in 2011.

The major theme from USA TODAY's 15th annual Investment Roundtable is that the bond market is looking riskier amid signs the economy is gaining traction. The five panelists say stocks, which get a boost from stronger growth, will post better returns than bonds in 2011. They are advising investors, many still leery two years after the financial crisis, to start shifting some investment dollars out of bonds and back into stocks.

"If you don't believe in a depression, and I don't," says **BlackRock**'s chief equity strategist Bob Doll, "stocks will go up and bonds will go down in the next few years."

Adds David Bianco, chief U.S. equity strategist at Bank of AmericaMerrill Lynch: "We're broadly bullish on U.S. equities. It's important for investors to get back into the asset class. Go buy mutual funds. Go buy index funds."

With the odds of a double-dip recession fading, assets perceived as safe, such as bonds, may be riskier than investors think. And "risk assets" like stocks may be better priced than they appear, says Abby Joseph Cohen, senior investment strategist for Goldman Sachs' Global Markets Institute.

Each panelist predicted double-digit gains in 2011. Dan Chung, CEO and chief investment officer at Alger Funds, was the most optimistic, saying stocks could rise more than 20% sometime in 2011. Earnings will surprise to the upside, he says.

Richard Bernstein, CEO and chief investment officer of Richard Bernstein Advisors, says U.S. stocks "sort of have the wind at their back right now."

Market outlook

Is it time for Main Street investors to sell bonds and buy U.S. stocks?

Since the start of 2009, individual investors spooked by the financial crisis have poured more than $664 billion into bond funds and fled stocks. They have yanked more money out of U.S. stock funds than they have put in for 32 straight weeks. Are they making a mistake by being too risk-averse at this time?

Abby Joseph Cohen, Goldman Sachs: The relevant part of your question is "at this time." My answer is yes, they are making a mistake. One can certainly understand why investors are so concerned. We have gone through an extraordinary experience between the credit crisis, very severe recession and extremely volatile markets.

But now that we're seeing that the U.S. economy has some traction, and the likelihood of a double-dip recession is remote, it's time to look again, not just at so-called risky securities like stocks, but to do the really hard work on valuation. Because a security that seems safe, if it is priced too high, is not safe.

I would put quite a few bonds in that category. To be buying a bond at record low yields makes one think that there is now risk there. Investors have to recognize that there may be risk in the so- called safe securities, but there's also the opportunity cost of not participating in some other securities.

When the economy does better, things like stocks and commodities tend to rise in price. U.S. equities are now trading between 13 and 14 times earnings, and that is significantly below the historical average. That suggests that there's good value there. Our 12-month market forecast for the S & P is 1450, (a 17% jump from Thursday's close of 1243).

Bob, what's your take on bonds vs. stocks?

Bob Doll, **BlackRock**: I echo everything Abby said. Let me add a couple of things. First, why are individuals shunning stocks? We cut them in half in 2000. We cut them in half again from 2007-2009. They're scared. That's to be expected. You have to ask, OK, what are the alternatives? And where have they been putting their money? We all know they've been selling stocks and buying bonds. You look at the big gap that's opened up in the valuation of stocks vs. bonds, and you've got to believe, unless the world is going to end and we are going to have a depression, that the gap is going to close.

If you don't believe in depression, and I don't, in the next few years stocks will go up and bonds down. And we all know that the public tends to buy after things are moving up. So maybe what we've seen in the last few weeks is the beginning of the reversal.

What kind of stock market returns do you expect next year?

Doll: Low double-digit returns, including dividends. The difference is, in 2010 the risks were more to the downside. In 2011, in my view, the risk is more to the upside. So if we're wrong, I think our forecast is too low.

Will higher stock prices boost confidence among consumers and investors?

Doll: We've been through a period of very low confidence: consumer confidence, CEO confidence. And there's nothing like a slightly better economy, a slightly better stock market to argue that confidence will beget more confidence. CEOs are never more confident than when their stock price is going up.

They will be more willing to do some positive things with the $2 trillion-plus in excess cash sitting on their balance sheets: raise their dividend; buy back their stock; engage in M & A; re-invest in their business; hire a worker or two; or maybe put up a new plant. I think that's what's in front of us.

David, do you agree that investors should consider taking more risk next year?

David Bianco, Bank of AmericaMerrill Lynch: Yes. We have just a little bit more of an optimistic outlook, about 15%, in total returns. And from the perspective of someone whose firm is the world's largest wealth adviser, with 16,000 financial advisors, to Abby and Bob's point, the past two years have been about return of capital rather than return on capital.

But when we talk to clients and we look at portfolios that are largely cash, Treasuries, municipal bonds and gold, we point out that that's just not a balanced portfolio. It's a portfolio with its own kind of risks, and a portfolio that, over time, is not going to keep up with your wants and desires for funding your long-term financial needs.

So you're recommending investors ratchet up their stock exposure?

Bianco: We are broadly bullish on U.S. equities. It's important for investors to get back into the asset class. Go buy mutual funds. Go buy index funds. Within the S & P 500, our advice is to stick with strength in 2011. And strength in the world is the emerging economies. But we want to point out that there are lots of plays on emerging economy growth within the S & P 500, particularly the technology, energy, industrial and materials sectors.

Rich, should people still fear stocks?

Richard Bernstein, Richard Bernstein Advisors: With individual investors, it's understandable what their attitude is, and it's been accentuated by the amplitude of the cycle. We've had such a big downturn that they've been very scared. But the important thing that they've forgotten is that there is still a cycle! What they've done is, they've seen a big downdraft and they've just extrapolated a trend down and down and down. That's not atypical.

So it's not unusual?

Bernstein: Markets go through four phases. The first phase is a period of denial, where people say, it can't happen (stocks rising despite risks), it won't happen, and if it's happening it can't continue. That's where we are in the U.S. The second phase is acceptance, like OK, I should probably be (buying stocks). The third is what I call the brave new world, things are never going to change, everything is wonderful. The fourth phase is the bear market.

What phase of the

cycle are we in now?

Bernstein: In the U.S. we're in phase one. The fact that the stock market is up more than 80% from its trough, and people refuse to believe that there's actually a bull market underway, reflects that we are in the denial phase.

Where I think there is more risk, and where we're closer to the brave new world and bear market scenario is in the emerging markets, where people do believe that there is something completely different going on, the world has changed and this is never-ending. There's clearly something going on there which is vastly different in terms of where we are in the stock market cycle in the U.S.

Investors are a little bit mispositioned in that they're probably in equity markets where they are taking more risk than they think they are. And they refuse to look at stock markets where the wind is at their back right now, and I would put the U.S. in that category. We've been telling clients to expect about a 15% rise on the S&P 500 in the next 12 months.

Dan, from a stock-picker's perspective, where are you on 2011?

Dan Chung, Alger Funds: In some ways I'm more bullish than anyone here. This year was characterized by three double-digit swings in the S & P 500. I think that volatility continues; it's a reflection of the uncertainty among investors. But I think the volatility continues on the upside, and we're going to hit 1500-plus at some point in the S & P 500 next year. We're going to see investors come back into U.S. equities next year, and we're going to see that U.S. returns are actually surprisingly good.

My only concern is I'm not so sure we hold it for very long, because the market is very volatile.

Why don't you think the gains will hold?

Chung: There are a lot of things that concern me about next year. In contrast to this year, where I was sort of cautious in the first half and bullish on the second, I'm a little bit on the reverse for next year.

Why is that?

Chung: China policy, which has been the topic of almost every conversation that affects macro issues, is going to be very tricky next year. The Chinese government is clearly not happy with their efforts to slow what they believe is a rising property bubble. We are going to see some more (policy tightening) action there. Finally, the rest of the world, including China, isn't that happy with what the U.S. Federal Reserve has been doing with (its easy- money policies). There are risks related to policy responses by emerging markets.

Everyone seems bullish.

What are key tail winds?

Will the deal to extend the Bush-era tax cuts and reduce payroll taxes give stocks a lift?

Chung: It's a very positive tail wind for accelerating something that's been occurring, which is increasing capital expenditures by business. The payroll tax cut is not insignificant in terms of putting more money in the pockets of working Americans. So, both of those are very pro growth.

Is the government turning more investor-friendly?Doll: We've been through a couple years where capital has been a bad thing, and people that had capital were bad people. This tax bill is saying returns on capital are good things.

Bianco: There's a positive signal that the Obama administration's No. 1 focus is now the economy and that they are treating investors a little more investor-friendly, at least for now.

Is the Federal Reserve, which announced plans to inject an additional $600 billion of stimulus into markets, going to be a positive or negative driver?

Bernstein: We can argue to great length as to whether all this monetary and fiscal policy is good for the long-term health of the U.S. economy. But it's hard to fight the fact that in the next 12 to 18 to 24 months, this is going to put the wind in the sails of the U.S. economy.

How can companies generate such big profits with so many people out of work?

Bianco: About 40% of the S & P 500's revenue comes from abroad, where many countries are growing at a faster clip than the U.S. The S & P has a lot of powerful indirect exposures to the world economy, via emerging market and commodity demand. Commodity prices are very important to the energy, industrial and material companies. Business spending also has a lot of connections to global growth. And that's what drives S & P earnings.

Why so bullish on U.S.?

What else is driving

corporate earnings?

Chung: Earnings are likely to be better than expectations for a while. Retail investors need to remind themselves that public companies represent some of the most dynamic innovation in our country. Netflix was recently added to the S & P 500. This is a company we invested in many years ago at $5 (Thursday's close: $181.65). Everyone knows it now. It's an example of zero international exposure, but pure innovation. Most of what it does is an old business of watching movies delivered by mail. Now they're moving to the Internet. This type of innovation is why U.S. stocks are very attractive now.

What are investors missing?

Doll: One of the big mistakes investors are making is using the U.S. economy and U.S. stock market in the same sentence, and they're increasingly unrelated. We've touched on companies getting 40% of revenue abroad. Our guess is over the next five years, 60% to 70% of incremental profits to the S & P 500 will come from outside the U.S. And while the consumer is not in as bad shape as a lot of people think, they're still two-thirds of the U.S. economy. But discretionary consumer earnings are only 15% of the S & P 500. They're very different numbers.

Cohen: Let me put some numbers on that. If you go back to the bottom of the bear market that ended in 2002, early 2003, S & P stock prices were up 35%, but S & P earnings were up 75%. And while that's sort of a gross measure, there are very few valuation approaches which suggest anything other than the U.S. stock market being inexpensive.

Companies have also piled up tons of cash on their balance sheets. Is that bullish?

Cohen: When publicly traded equities are inexpensively priced and corporations have cash sitting on the sidelines, they can do several things with that cash. They might pursue M & A activity. They may take a look at one of their competitors, or another company that they think might add to their business. They could return capital to shareholders in the form of a tax-advantaged share repurchase. They can also increase the dividend. We expect all of this to happen. All of this is positive for the stock market. The numbers involved are probably larger than that of individuals coming into the market.

Bianco: Good point. Even if the retail client base doesn't come back to the stock market, you'll see corporations buying their shares. We also think asset-allocation funds will be moving into equities.

How can stocks go up if the economy remains sluggish, compared to prior recoveries?

Bernstein: Individual investors are very scared of the equity market. Part of that is because they hear a lot of economists talk. There's a big difference in the way an economist looks at the world and the way an investor does. I don't think most people realize that the stock market does not move on good or bad economic numbers. It moves on better or worse.

If you're an individual investor, when you look at the data, most people would have to say there's a pretty good probability the U.S. economy will be better a year from now than it is today. Therefore, you should be at least reasonably bullish.

Shouldn't investors worry about interest rates soaring and hurting their bond holdings?

Bernstein: I don't even think you have to be really wigged out about inflation to say that there's a little more risk in bonds than people think. Not that we're going to have massive inflation from printing dollars and that we're going to turn into Argentina. But the economy is simply going to get better, and as the economy gets better, you're going to have normal upward pressure on long-term interest rates. I don't think individuals can conceive that we could actually have a normal increase in long-term interest rates. It's not on their radar screen. But, in my opinion, that's where the risk really lies right now.

Does anyone consider the third year of the presidential cycle, which has historically been bullish for stocks, as a tail wind?

Chung: I happen to think that the first half of 2011 will actually be somewhat positively biased, because I think that the new Congress is indicating that they want to get things done, as opposed to nothing. The risk is gridlock, and the market would be unhappy with gridlock. Both President Obama and Congress are well aware of that sentiment in the public. I think that's what the election results really mean, that we don't want to see gridlock, we want to see some compromises. And we're seeing that. It's very positive, in that sense. I don't think it's so much tied to the third-year cycle necessarily.

Isn't the typical reasoning that stocks do well in the third year of the cycle because the politicians are already worrying about re- election and, therefore, taking steps to prime the pump to get the economy firing on all cylinders?

Doll: Well, look at the tax-cut package that's in the process of going through. We talked about why it's a positive for growth, and part of the reason is these guys are saying, if I want to get re- elected in

If the tax-cut deal is passed, how will it boost markets?

Doll: A lot of economists are using the potential passage to raise their economic growth expectations. In September, October, November, almost every statistic was a little better than the last one. I think they're realizing that their numbers weren't high enough. A lot of economists are boosting their GDP growth expectations from around 2% to 3%.

What about the impact of the U.S. dollar? It's showing strength after months of weakness.

Bernstein: Normally people say a weak dollar means your exports are going to go up, and there's something to that, although I don't think we're a big manufacturing economy. We export services and agricultural things, and that type of stuff.

But a stronger dollar will be a positive because it will reflect renewed confidence in the U.S. If there's one theme that transcends every bearish view -- whether it's inflation, deflation, economic malaise -- the general consensus is: You should not invest in the U.S.; there's no future in the U.S.; we're on our way down to some new low in global society. It's quite dramatic. My point is that in 2011 into 2012, people will be surprised by the growth in the U.S., and you will see investment flows come towards the U.S., and that will be a big support for the dollar.

Bianco: A stronger dollar will be a bit of a head wind to earnings growth, but there will still be strong earnings growth. The focus is going to shift to interest rates: How far can they go up? A stronger dollar is going to help keep interests rates from going up a whole lot. It's also going to attract foreign investors to things like the U.S. equity markets.

Will higher stock prices create a wealth effect and boost the economy and stocks?

Chung: Where the wealth effect tends to play out very directly is in upper-end consumers that have a lot of discretionary income. We're watching very carefully how the luxury goods manufacturers, or companies that service higher-end consumers, are doing. They've seen some of the strongest comebacks. It seems very unlikely that that gets derailed in 2011. I think sentiment improves, as does spending on higher-end luxury items, and more actual investing in U.S. stocks, something that even high-end consumers have been shy of in the last couple years.

Cohen: The wealth effect impact will be very different on middle- income investors than on others. For many middle-income families, their most significant asset is still their home. Middle-income families and lower are skewed much more towards fixed income. So even if we were to see a meaningful rally in stocks, the impact would be very uneven in terms of which families would benefit.

List

How high is high for the stock market in 2011: Base on year-end 2011 price targets for S & P 500, here are the price gains panelists predict:

David Bianco

13.2% 2011 S & P close: 1400.

Bank of AmericaMerrill Lynch

Chief U.S. equity strategist

IBM ($144.55, Thursday, ticker IBM). The computing giant fits the theme of big international growth stocks that can profit from growth in emerging economies around the world.

Google ($591.71, GOOG). The search giant is expanding its reach and will benefit from more corporate spending on mobile computing.

United Technologies ($79.02, UTX). Big, geographically diversified industrial company is a play on Asian urbanization, aircraft demand and energy efficiency process controls.

Occidental Petroleum ($94.84, OXY). Energy company is sensitive to oil prices, which will average $85 a barrel in 2011 but will top $100 during the year.

Walt Disney ($37.01, DIS). This consumer discretionary stock has a great brand and will profit from replicating its business model -- media, films, theme parks and resorts -- around the world.

Dan Chung

21.3% 2011 S & P close: 1500

Alger Funds

(Fred Alger Management)

CEO and chief investment officer

Lowe's ($25.45. Thursday, ticker LOW). Home improvement retailer could double depressed profit in 2011 thanks to an eventual housing recovery and more repair- and maintenance-related purchases by consumers if real estate market lags.

OpenTable ($70.87, OPEN). Free online restaurant reservation play is fast-growing small stock serving 15,000 clients with plans to feed growth in foreign eateries around the globe.

Apple ($321.25, AAPL). Fifty percent-plus 2010 gain for iPad and iPhone maker isn't a barrier to 2011 rally given high-teens profit growth estimate and reasonable valuation.

Qualcomm ($49.65, QCOM). High-quality maker of chips that power mobile phones will benefit from telecom transformation to wireless, PC-like smartphones and 4G networks.

Cognizant ($70.41, CTSH). A tad expensive but best-of-class IT outsourcer will gain business from struggling European economies and cost-conscious U.S. cities and states.

Richard Bernstein

15%

Richard Bernstein Advisors

CEO and chief investment officer

Small-caps sized right. In a bet on a positive economic surprise in U.S., small-company stocks, which have posted bigger gains than China stocks for three years, are set up for more success.

Buy U.S. municipal bonds. The hot trade has been buying sovereign debt of emerging market countries, but risks are rising. A basket of U.S. "muni" bonds issued by municipalities, cities and states -- which investors have been avoiding -- is a good total-return play.

Profit from economic rebound. As the economy enters the midphase of its recovery cycle, the global reach of the energy and materials sectors should make them market leaders.

Go long on the U.S. dollar. Despite talk about the U.S. central bank debasing the dollar with its easy-money policy, the dollar, which troughed in 2008, is set to appreciate.

Long live the U.S. consumer. Money managers' love affair with stocks that benefit from spending by emerging market consumers is likely to fade as inflation crimps buying power abroad. With the U.S. jobs picture brightening, U.S. consumer stocks could be a positive surprise.

Bob Doll

9.1% 2011 S & P close: 1350

BlackRock

Chief equity strategist

Marathon Oil ($35.17 Thursday, ticker MRO). If the global economy is going to grow, demand for energy will grow and drive prices up, fueling integrated oil plays such as Marathon Oil and Conoco Phillips ($65.67, COP).

Eli Lilly ($35.18, LLY). To get growth no matter how the economy fares, consider drugmakers Eli Lilly and Bristol-Myers Squibb ($26.72, BMY), which sport fat dividend yields, decent free cash flow and must-have pharmaceuticals.

Verizon ($34.76, VZ). Telecom giant is in a price-competitive space but sports a nearly 6% annual dividend yield; greater data use by mobile users and new smartphone products give it an edge.

General Electric ($17.77, GE). Global company is a low- expectation stock with rebounding industrial businesses and a financial lending arm that is getting healthy in the post-financial crisis.

Dell ($13.33, DELL). Onetime computer powerhouse's business strategy faces questions, but it's a cheap stock with strong cash flow and a good risk/reward profile.

Abby Joseph Cohen

17.2% 2011 S & P close: 1450

Goldman Sachs

Global Markets Institute

Senior investment strategist and president

Cash in on global economic rebound. Seek out stocks with the ability to post strong revenue and profit growth where all the good news has not already been priced in.

Favor developed markets. Emerging markets like China have been getting most of the attention, but stocks are less pricey and, thus, more attractive in the U.S., Europe and Japan.

Snap up sectors that thrive in recoveries. Information technology is good early cycle play; select financials offer value as markets improve; energy gets global demand boost.

Profit from stock market resurgence. Wall Street banks and asset managers are likely to rise along with stocks, as fee income rises and underinvested folks shift cash back to stocks.

Beware bond mutual funds. Bond funds are not as safe as they appear. If interest rates start going up and bond investors sell, individual investors will suffer losses.

List

11 money-making ideas for 2011

1

Go B.I.G.

This acronym means "big international growth" stocks, says David Bianco of Bank of AmericaMerrill Lynch. U.S. multinationals in the S & P 500-stock index are well positioned to take advantage of peppy, global-led growth in emerging markets, where a new middle class with an American-style consumption mentality is forming. "We're looking for companies that can take capital from the U.S. and redeploy it into faster-growing economies," says Bianco.

2

T.I.M.E. spells opportunity.

The sectors best positioned to cash in on faster growth in overseas economies are Technology, Industrials, Materials and Energy, Bianco says.

3

Dividend growers

Bianco likes dividend payers, but with an emphasis on dividend "growers." He says dividends paid out by S & P 500 companies will jump by about 50% to $38 per share in 2012. Fatter dividends add up to more sizable total returns.

4

Money protector play

Steer clear of gold, says Richard Bernstein of Richard Bernstein Advisors. With the yellow metal trading near $1,400 an ounce, stories about gold vending machines making headlines, the dollar appreciating again and inflation subdued, gold amounts to a "momentum play," he says. "Momentum markets are a lot of fun. The problem is: They go down faster than they go up. We're in the seventh, eighth or ninth inning of the gold story. I'd be looking for stories other than gold."

5

U.S. stocks over bonds

Investors' rush into the perceived safety of bonds, especially U.S. Treasuries, and avoidance of U.S. stocks, may no longer make sense. "I am a big fan of stocks over bonds," Bernstein says. With the economy in a more normal cycle than people think, and the recovery taking hold, interest rates should begin to feel upward pressure, he says. A better economy will translate into more profits for companies, which is bullish for stocks. The flip side of rising bond yields is falling bond prices, which translates into losses for bond fund investors.

6

Follow the free cash-flow trail

Companies that generate a lot of cash have more options when it comes to managing growth and sharing profits with investors. "Strong free cash flow helps a company and helps the stock," says Bob Doll of **BlackRock**. The biggest plus: It gives a company more flexibility when it comes to "reinvesting in their business," he says. They can increase dividend payouts, buy back more of their own stock, and do deals via mergers and acquisitions. "And that's important," Doll says, "in a world that's growing better than it did in the past 12 months but still at a sub-par rate."

7

Geographic pairs

If you're trying to discern the best investments in established economies, emerging ones or in debt-troubled Europe, Doll recommends: U.S. over Japan; Brazil over China; and Germany over peripheral Europe.

8

Beware bond mutual funds

"Investors need to be careful owning bond funds," says Abby Joseph Cohen of Goldman Sachs. "I'm concerned about individual investors who have basically said, 'I'm safe in a bond mutual fund.' They may not be." The risk is that unlike an individual bond, which pays out a regular dividend and pays back the principal at the end of the borrowing term, bond funds can lose value if investors dump shares. To better know what they're getting, "Individuals should buy individual bonds and hold them until maturity, which dramatically reduces the likelihood of principal loss," she says.

9

Return on equity is king

Sure, you want companies that generate cash. But the best cash- generating companies are those with good returns on equity. "Sometimes companies late in their life cycle are generating a lot of cash, but because their business is mature, they don't have anything internally to invest it in," Cohen says. The key: Find a company generating cash that can reinvest those proceeds in something that will generate good returns.

10

Quality, quality, quality

Look for high-quality growth companies, says Dan Chung of Alger Funds. Seek "companies that can grow in a slow environment or grow at a superior rate in a faster-growth environment," he says. "Essentially, market share leaders, market share gainers."

11

Invest in infrastructure

"Where are the infrastructure needs? The companies that supply goods and services to those markets will do well, whether globally or in the U.S.," Chung says.

List

What could go wrong

The fact that all of the panelists have outlined upbeat forecasts for the stock market in 2011 is somewhat worrisome, as history has often shown that when everyone is in agreement on a certain outcome, the exact opposite often occurs. So, in the spirit of full disclosure and contrarian thinking, here is what this year's roundtable experts say could go wrong and derail their bullish predictions.

Job recovery stalls out

"The No. 1 thing we are following is employment," says Richard Bernstein of Richard Bernstein Advisors. "We are watching this leading indicator like hawks. Right now, the jobs data are all improving. But if we started seeing them all roll over, we would not wait to see what would happen: We would reposition our portfolios (more conservatively) pretty quickly."

Gas prices spike at the pump

"The other thing we're watching carefully is the effect of, say, increasing gasoline prices on the consumer," Bernstein says. "That's not a worry right now, but we always look at gas prices very closely, because not only does it infringe on purchasing power in other areas of the economy, but it's also a psychological issue, that every time you ride down the road you get the sign in front of you telling you how much prices are going up."

Housing hurt by rising rates

"Home prices in the U.S. have been flat (or stabilizing) for a bunch of months now, (despite) support from low interest rates. And the question is, at what level do rates begin to threaten that trend?" says Bob Doll of **BlackRock**. "We have to keep our eye on housing and all the credit issues related to that. I think we will muddle through, but it is certainly a risk."

Negative impact

of rising cost pressures

While the Federal Reserve keeps downplaying inflation fears, investors should keep an eye on rising costs for food and energy, as well as commodities and the pass-through costs that could make their way into raw materials and finished goods, Doll says. "Higher costs also put pressure on the (positive) earnings story," he says.

Policy pitfalls abroad

Not only is the progress of financial markets affected by what policies are implemented by lawmakers here, but what decisions are made by foreign governments, says Abby Joseph Cohen of Goldman Sachs. "It's really very striking to me that during the worst part of the credit crisis in 2008, we had incredible levels of cooperation between all the major economies of the world, because everyone recognized that we were all in this mess together," Cohen says. "Now that we've moved away from the crisis stage, we see that domestic politics are taking hold in any number of countries. In general, we are seeing less cooperation, or less harmonization of policy, than we did two years ago. And so we, as a global economy, need to be thinking about whether, for domestic political reasons, bad policy decisions are being made."

Growth-slowing trade conflict

"I'm concerned about the potential for trade conflict and currency controls," says Dan Chung of Alger Funds. Markets around the world have already been affected by so-called currency wars, when countries take steps to weaken their currencies in an attempt to make the goods produced in their countries and exported around the world cheaper. And many countries, including the U.S., have taken China to task for keeping its currency artificially low to boost its export competitiveness. "There's risk, both political and for the markets," Chung says.

Buying strike by rank-and-file investors continues

A positive surprise for the stock market would be if Main Street investors finally come back to the U.S. stock market, after yanking money out of stock mutual funds for 32 straight weeks. "Watch where the equity flows go," Chung says. If individuals don't get back into the market it would be a bearish development. "What people do with their money will be interesting to watch," he says. "Just because many experts believe that they should come back into U.S. equities, doesn't mean they will."

Political gridlock sets up camp in Washington

All the panelists agree that politicians must compromise and make intelligent decisions that boost growth in the short term and establish a framework for dealing with longer-term issues, such as the ballooning budget deficit, a weakened education system and an unsustainable entitlement system that pose risks down the road. "Gridlock would not be good," Doll says. "The easy part of passing fiscal packages like the tax-cut extension and cuts is doing it and getting it out of the way. The hard part is to tackle the deficit issue, the accumulation of all that debt, because that could come back and bite us in the face if we just sit there and twiddle our thumbs."

Dollar's continued strength crimps U.S. corporate profits

If the greenback continues to strengthen against the euro and other foreign currencies it could act as a drag on profits of U.S. companies, says David Bianco of Bank of AmericaMerrill Lynch. A weak dollar, of course, makes products made in the U.S. cheaper for foreign buyers, which boosts sales and profits for U.S. companies. That dynamic could be altered if the dollar rallies, making U.S.- made products less affordable abroad. "That's one of the headwinds to earnings," Bianco says.

PHOTO, Color, Robert Deutsch, USA TODAY; PHOTO, Color

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MONEY

It's time for the big capital gains reveal ; News determines what kind of tax bill investors can expect

John Waggoner
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Mutual fund companies are revealing their estimated capital gains payouts for 2010 -- and if you're considering buying a fund now, be sure to wait until after it has made its distribution.

This year's distributions aren't as bad as they have been in other years. "A lot of funds still have losses built up from the 2007-2009 bear market that they can use to offset gains," says Dan Culloton, associate director of fund analysis at Morningstar.

But some sectors have done well enough that shareholders will have to give part of their gains to the tax man.

*Gold funds. They have a searing 34% gain this year, and several will make capital gains distributions. Fidelity Select Gold, for example, will pay an estimated $1.71 a share in short-term and $2.25 in long-term gains, about 7% of its current price.

*Energy funds. Vanguard Energy fund's Admiral shares will pay an estimated $3.28 a share in capital gains, about 2.7% of the fund's current share price.

*International and emerging markets funds. **BlackRock** Pacific will pay $1.10 a share in long- and short-term capital gains. Its total distribution, with dividend income, is 6.9% of its share price.

Some bond funds, too, are doling out capital gains distributions this year, because the bond market has been so hot the past few years. For example, Pimco 7-10 Year U.S. Treasury Index fund will pay $1.05 per share in short-term capital gains this year. That's about 1.3% of the fund's share price.

Funds don't pay capital gains taxes when they sell a stock or bond for a profit. Instead they pass gains on to investors, usually in a year-end distribution. If you're thinking of buying a fund in a taxable account, wait until after the fund has made its distribution. "You don't want to have to pay taxes on gains you didn't receive," Culloton says.

Distributions can be costly. Dividends paid on holdings the fund owned for less than a year are taxed the same as income. Qualified dividends -- those on stocks held for more than a year -- are taxed at a maximum 15%. Most dividends from real estate investment trusts are taxed as ordinary income. Short-term capital gains, from securities held less than a year, are taxed at your income tax rate. Long-term gains are taxed at a maximum 15%.

When you receive a dividend or capital gains distribution, your fund's share price drops by the amount of the distribution. Most people reinvest the distribution. If you own your shares in a tax- sheltered retirement fund, you don't have to worry about capital gains or dividend distributions.

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MONEY
Smiling stocks, bummed out bonds

John Waggoner
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English

The Federal Reserve is launching its second round of quantitative easing, and stock investors should get a rise out of it. But savers and bondholders might not be too happy.

QE2 will pump more money into the system to avert deflation -- a period of falling prices.

The Fed's action was widely anticipated, so much of its impact may have already been priced into the markets, says Bill Stone, chief economist at PNC Financial. "It was the least-kept secret on the planet," he says.

Still, QE2 might be good for stocks, because it may force money from bonds and savings accounts into the stock market. Higher household 401(k) balances and brokerage accounts will make people feel wealthier and spend more, stimulating the economy, Stone says.

Higher stock prices make corporate leaders less cautious. "There's nothing that makes a CEO more confident than his stock price going up," says Robert Doll, chief equity strategist for fundamental equities at **BlackRock**. Other consequences:

*A weaker dollar. All other things being equal, more greenbacks in the system means a lower value for each dollar. When the dollar falls, U.S. exports are cheaper, which boosts manufacturers. A falling dollar also gives international funds a lift: Gains from abroad rise in value when the dollar drops. But the dollar won't collapse, says Ken Heebner, star manager of CGM Mutual.

"There's no alternative currency," Heebner says. Investors have lingering doubts about the euro, the value of China's currency is determined by its government, and the Japanese yen is too narrowly based, he says.

*Low mortgage rates. Mortgage rates follow Treasury rates, which the Fed aims to keep low through QE2. The average 30-year mortgage rate is 4.23%, says mortgage giant Freddie Mac, down from 5.09% at the start of 2010.

*Higher inflation. The Fed is fighting deflation with inflation, and QE2 will probably do just that, eventually. The normal beneficiaries of modestly higher inflation are stocks, commodities and precious metals. If the Fed loses control of inflation, however, stocks will get hurt.

Bond investors won't like the Fed's campaign. Bond traders view inflation the way Dracula looks at sunlight. When inflation rises, traders push bond prices down and interest rates up.

Income from bonds won't be enough to compensate for falling bond prices, Heebner says. (If you hold a bond to maturity, however, you'll get the face value of your bond when it matures.)

There's no relief in sight for savers. Rates on money market mutual funds and bank CDs track the fed funds rate, which is currently stuck between zero and 0.25%. The Fed is unlikely to raise those rates until it's sure the economy is growing.

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MONEY
TD Ameritrade lets customers trade some ETFs for free

Matt Krantz
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TD Ameritrade starting today will allow customers to buy and sell more than 100 exchange traded funds with no commission, escalating the intense price war among online brokerage firms.

Exchange traded funds, or ETFs, are increasingly popular investments that allow investors to buy a basket of securities just as they'd buy a single stock.

The 101 ETFs that qualify for no-commission trades were selected as the best in their categories by independent investment research firm Morningstar. ETFs from a variety of providers are included, ranging from **BlackRock**'s iShares, Vanguard and State Street. ETFs on the list are expected to stay on it over time, says TD Ameritrade's Peter Sidebottom.

The elimination of ETF commissions by TD Ameritrade, one of the largest brokerage firms, follows free ETF trades announced this year by rival brokers Charles Schwab, Vanguard and Fidelity. Schwab's zero-commission ETF program, though, is limited to 11 of Schwab's own ETFs. Vanguard's free-commission deal is restricted to its own 47 ETFs. And Fidelity offers free trading in 25 iShares ETFs.

TD Ameritrade's zero-commission program is designed to appeal to long-term investors. If investors do not hold the ETF for 30 calendar days, the brokerage's standard $9.99 per trade commission will be charged.

TD Ameritrade's move extends free trades to investors who couldn't qualify for similar deals at other brokerages before. Most large online brokers with free ETF trading require $1,000 or more to open accounts. Other brokerages, including Zecco, Wells Fargo and Bank of America, offer a limited number of free trades on any stock, including ETFs, but a minimum account balance of $25,000 is required to qualify.

The no-commission offers for ETFs have not accelerated the move of investors into the investments so far, says Matthew Hougan, president of ETF analytics at Index Universe.

Even so, such price breaks make ETFs even more compelling for investors to quickly, easily and inexpensively create diversified portfolios that they can hold long term, he says. "If you're a long- term buy-and-hold person, chances are you're now better off with ETFs than competing mutual funds."

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MONEY

Time to take stock of your bonds ; The specter of rising interest rates could put a dent in your portfolio

John Waggoner
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We had another taste of a bear market in stocks last week, but it's probably time to worry about a bear market in bonds. Normal bond bears are like trips to the dentist: not much fun, but probably good for you.

What Wall Street is worried about is whether this is a mega-bear market in bonds, which is more like a trip to the cardiac unit on a stretcher carried by clowns. Those fears probably aren't justified. Still, it's a good time to take a few precautions with your bond holdings.

Why worry about bonds? From a contrarian point of view, bonds have become so popular that they're due for a shellacking. Investors put a net $376 billion into bond mutual funds last year, a record- shattering figure. In contrast, the record inflow to stock funds was $309 billion, in 2000.

Investors are still showing the love this year. They have poured an estimated $112 billion into bond funds through May 5, says the Investment Company Institute, the funds' trade group.

You normally see such enormous flows into funds at the top of a market, not at the bottom.

So what could go wrong? The most likely culprit is rising interest rates. This bears some explanation.

Bonds are long-term, interest-bearing IOUs, issued by the federal government, state and local entities, and corporations. Consider one of the most popular bonds on the planet, the 10-year Treasury note. The most recently issued 10-year T-note matures on March 15, 2020. It pays 3.5% a year in interest, paid semiannually.

If you had bought a $1,000 T-note, you could expect to get $35 in interest every 12 months for the rest of the decade, at which point you'd get your $1,000 back. And as long as you held your bond to maturity, you'd be very sure of getting timely payments of interest and principal.

But let's say that you wanted to sell your $1,000 T-note a year later. There's a wrinkle: Newly issued T-notes now yield 5%. Bond traders would point and laugh at your T-note, which yields just 3.5%.

You can't change your bond's interest rate, called the coupon rate. But if you were desperate to sell your bond, you could sell it for less than face value, which would increase its yield -- interest payment divided by principal.

As a crude example, suppose you cut your bond's price to $700. The bond's yield would rise to 5%, and you'd take a 30% haircut on your principal. (Bond traders use a far more precise measurement, called yield to maturity, but you get the idea.) If rates fell, of course, you'd be able to sell your bond for a profit.

Last year, the 10-year T-note yield rose from 2.24% to 3.84%. Funds that invest in U.S. Treasury securities fell 9%, including reinvested interest, according to Lipper, which tracks the funds.

Interest rates are still unusually low, and could rise more, says Tad Rivelle, chief investment officer for fixed income at the Trust Co. of the West. The yield on the 10-year note has averaged 5.5% the past two decades. He thinks rising public debt will push rates to 5.5% to 6.6% before this cycle has ended.

That's the bad news. The good news is that the prospects of a catastrophic bear market in bonds -- one that features spiraling corporate bond defaults -- are probably receding. Defaults peaked in the first quarter of 2009, says John Lonski, chief economist for Moody's Investors Service. The current default rate is 9.5%, and he expects that to fall to 3% by year's end as the economy recovers and corporate profits increase.

Corporate bond funds tend to fare well when the credit cycle is on the upswing, even if rates rise. At the end of 2008, bond traders assumed that all corporations would be in bankruptcy by 2010. As credit conditions improved, bond prices rose. The average fund that invested in high-quality corporate bonds rose 14.7%.

The wild card is Europe: If debt liquidation starts abroad, we could see it spread here. Already, yields on lower-quality bonds have started to rise, reflecting traders' unease about world finances. What's a bond investor to do? A few suggestions:

*Consider individual bonds, rather than bond funds, and hold them to maturity.

*Don't buy long-term bonds, which see greater price swings than short-term bonds when rates rise.

*Stick with investment-grade bonds. Yields on high-yield, high- risk bonds aren't high enough to reward you for the risk, Rivelle says. But you can get some decent returns from big bank bonds, such as those issued by Bank of America and Citigroup.

You might also consider inflation-adjusted bonds, whose prices rise with the consumer price index, the government's main gauge of inflation. Now, 10-year Treasury Inflation Protected Securities, or TIPS, are priced for an average 2% inflation rate for the rest of the decade. If the inflation rate rises sharply, TIPS should fare well.

John Waggoner's column appears on Fridays. E-mail: jwaggoner@usatoday.com. Follow him at www.twitter.com/johnwaggoner.

List

Some bond funds worth noting

Top-performing inflation-adjusted bond funds the past five years with annual expense ratios below 0.75%.

Total return

Fund, ticker 2010 5 years

BlackRock Inflation-Protected Bond A, BPRAX 3.0% 31%

American Century Inflation-Adjusted Bond, ACITX 2.9% 26%

Vanguard Inflation-Protected Bond, VIPSX 3.1% 26%

T. Rowe Price Inflation-Protected Bond, PRIPX 3.2% 26%

MFS Inflation-Adjusted Bond, MIAAX 2.9% 22%

Average inflation-adjusted bond 3.1% 25%

1 - Dividends, gains reinvested through Wednesday. Source: Lipper.

PHOTO, B/W

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MONEY
Bull market turns 1 -- time to party, or worry? ; Judging by history, it's still just a baby

Adam Shell
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NEW YORK -- It is hard to kill a bull market in its first year of life. The last time a baby bull was buried on Wall Street before celebrating its first birthday was during the Great Depression.

It is just as rare for stock bull markets to die before they turn 2. You have to go back to 1947 to find a bull rally that didn't last at least 24 months.

On average, the life expectancy of a bull market is nearly four years, according to InvesTech Research.

Why are data on bull market mortality rates relevant?

Because on Wednesday, investors will celebrate the first birthday of the current bull market -- the one born a day after stocks hit rock bottom on March 9, 2009, ending the second-worst stock market meltdown in history.

But since investors are forward-looking animals who deal in probabilities when making decisions, their focus will shift quickly to what's next for the market. And how stocks performed in the early stages of powerful uptrends in the past provides a roadmap for still- nervous investors wondering how long the good times can last.

"It's not that bull markets can't end in less than one year or two years, ... but the historical odds are in our favor," notes James Stack, editor of InvesTech Research, in a note to subscribers.

Optimists contend that there are plenty of reasons the odds point to a second year of gains. But investors shouldn't expect the same kind of shoot-the-lights-out type of returns. "The first year will win the prize by far when it comes to magnitude of returns," predicts Bob Doll, chief equity strategist at **BlackRock**.

Still, the continuing tailwinds from all the government stimulus injected into the economy, Doll says, should be powerful enough to overcome the headwinds associated with consumers paying down debt and fast-rising government deficits.

But Doll warns of bumps along the way. "We will see more aftershocks like the Greek debt crisis from the major financial earthquake of late 2008 and early 2009," he says.

Bull markets tend not to fizzle quickly for one simple reason: "Normally, economic recoveries last a couple of years," if not longer, says Tobias Levkovich, chief U.S. equity strategist at Citi Investment Research.

So unless the economy suffers a double dip, the ongoing expansion -- even if it is less robust than normal -- should translate into stronger-than-expected profits for U.S. companies, Levkovich says. Earnings are a key driver of stock prices. "I think the market rallies this year," he says.

But haven't stocks raced up too far, too fast and gotten ahead of the slow pace of the recovery, setting them up for a fall?

No, says Stephen Auth, chief investment officer of equities at Federated Investors.

Auth rejects the most-cited reason skeptics use to predict the rally's demise, namely that the Standard &Poor's 500 index's nearly 70% rally since the bear market low suggests that there is little upside left.

"The (bear market closing low of 676.53) was a false low," says Auth. He says the market fell to an artificially depressed level due to fears of the entire financial system collapsing.

Auth argues that a better level to look at to get a more accurate gauge of the size of the market's rebound is the intra-day low of 839.80 hit on Oct. 10, 2008, as it came on record trading volume of more than 11 billion shares -- more than one-third larger than the day of the March 9, 2009, low. With the S&P at 1138.50 the market is up only 36% from the 840 level.

"For people to say we have already (priced in) the sharp economic recovery is nonsense," Auth says. "We haven't even (recouped all the losses) caused by the Armageddon scenario. We haven't even gotten back to 1250." That was where the S&P 500 was trading before the mid- September 2008 bankruptcy filing of Wall Street titan Lehman Bros., an event that arguably triggered the financial crisis.

The bear side of the equation

So what would it take to end the bull market prematurely? A 20% drop, which is the definition of a bear market. A dip of that magnitude is possible, say more skeptical market strategists.

"You can't rule out a drop of 20% now or ever," says Michael Farr, president of money management firm Farr Miller &Washington.

Risks to the economic outlook remain, Farr stresses. He points out that Federal Reserve Chairman Ben Bernanke said recently that the "recovery is not yet self-sustaining." Farr worries that it will be tough to get a consumer-led expansion going with so many people saddled with high debt and job insecurity. Consumers are key to a revival because they account for roughly two-thirds of economic activity in the U.S.

"This is a wait-and-see period for the economy," Farr says. "The main cliffhanger is whether the ample supply of government dollars will find traction and, in time, lead to renewed growth and hiring. Markets are plenty vulnerable to shock and disappointment right now. Investors are undecided. Yell 'Boo!' and they may all run for the door at once."

Jobs are a big factor

Another risk is jobs. Simply put: If the economy can't generate jobs, and jobless claims increase sharply, "The bull might be over," says Richard Bernstein, CEO of Richard Bernstein Capital Management. The flip side is if jobs come back, it is very bullish for stocks, he adds. Citing a still-skeptical investor base, a strengthening dollar, which makes U.S. assets more attractive, and a strong profit outlook, Bernstein says there is a "very good probability the bull market continues to its second birthday."

The average stock mutual fund was up 55% in the 12 months ended in February. So protecting gains is a paramount concern to Main Street investors, many of whom saw their portfolios slashed in half in the 2007-2009 bear market.

Still, the notion that stocks still have room to run simply because they are not back to where they were before the worst fears of investors caused a selling stampede is just part of the bull's story.

Bulls make their case

The other key building blocks of the bull case include:

*Major roadblocks still absent. Two of the biggest rally killers - - interest rate hikes by the Federal Reserve and a big spike in inflation -- "simply are not present yet," says James Paulsen, chief investment strategist at Wells Capital Management.

Many investors are worried that the Fed's so-called exit strategy, in which the U.S. central bank drains cheap money from the financial system and boosts borrowing costs in an effort to stave off inflation, will put what Bernanke dubs the nascent economic recovery in jeopardy. But Paulsen argues that even if the Fed starts to raise short-term interest rates, currently near 0%, it won't spell the end of the stock rally. The rally is not at risk, he argues, until sometime after the Fed begins to raise rates.

*Investor fear still present. Typically, stock rallies run into trouble when investors get too optimistic, too complacent and too convinced that profiting in the stock market is a sure thing. But despite the big gains in the first year of the bull, sentiment is anything but ebullient.

And from a contrarian standpoint, that is bullish.

Not only are stocks climbing the "Wall of Worry," they are also dealing with more daunting "Cliffs of Concern," says Citi's Levkovich.

"There is all this stuff to worry about," Levkovich says. "Debt problems in Greece. China tightening its monetary policy (or its property bubble bursting). Commercial real estate woes. What about the banking sector? What about jobs? What about underfunded pension plans? It goes on and on.

"I am not saying these problems are not out there, or that they are irrelevant," Levkovich says. "We do have reason to worry."

But investors must recognize, Levkovich adds, that all these risks get priced into the market. More important, investors must realize that if any better-than-expected news surfaces, the markets have room to go higher.

*Earnings power is underappreciated. Optimists such as Federated's Auth are betting that the economic recovery will be stronger and last longer than the current consensus opinion on Wall Street. Most economists are calling for a subpar recovery due to banks cutting back on credit and the ongoing process of individuals paying down debt after years of spending beyond their means.

If Auth is right, and manufacturing is in the early stages of recovery, and job growth is about to turn positive and U.S. companies with major foreign operations continue to reap big profits in faster-growing emerging markets, corporate profitability should be better than analysts are now predicting.

Profits will also benefit from the fact that most companies prepared for a depression that never happened by cutting costs and headcounts. So when sales pick up, the profits will pile up more quickly on the bottom line.

"We have earnings rebounding substantially in the next couple of years," Auth says.

How big a rebound? Analysts' consensus estimate for 2010 earnings for S&P 500 companies is roughly $76 per share, and Auth is estimating closer to $85 to $90, which puts the current market price- to-earnings ratio at around 12.7, which is below the long-term average of 15.

*Cash on sidelines still piling up. "We still have a ton of sidelined cash, or dry powder, sitting on the sidelines," says Paulsen. By his estimates households have upwards of $7 trillion sitting in cash or cash equivalents. Because most of Americans have bought into the "new normal" thesis of less spending, less risk- taking and lower returns, Paulsen says there could be a lot of "potential converts" who might have to switch to a more aggressive strategy and buy stocks if the recovery is better than economists think.

Ever since the financial crisis began, money flows into domestic stock funds have been woefully small, as investors have flocked to the perceived safety of bond funds.

That trend continued in the week ended Feb. 24, the most recent data available, as domestic stock funds had inflows of just $151 million, vs. nearly $8 billion going into bond funds, according to the Investment Company Institute.

Summing up future risks

But bears such as Michael Panzner, who writes the blog Financial Armageddon, say bulls are "blind to the worsening economic reality all around them," and in danger of getting hurt again by falling asset prices.

Headwinds are plentiful, Panzner says.

There has been little improvement in bank lending or credit availability, he says. The "long-term unemployment situation is getting worse" and economic data, which had been pointing up, have flattened out recently, suggesting a growing risk of a double dip, or economic relapse, he says.

The banking system also remains weak, as is the financial position of sovereign states such as Greece as well as states such as California.

He predicts a not-too-pretty fallout.

"In my view, the effect will be, at the least, a retest of what we saw last March," Panzner says. "At worst, much lower lows. It may not happen in 2010. However, it could be over the next couple of years."

GRAPHIC, Color, Web Bryant, USA TODAY (Illustration); GRAPHIC, B/W, Karl Gelles, USA TODAY, Source: Standard &Poor's Equity Research (Bar graph)

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MONEY

How will the arrow point in 10 years? ; This decade was a big fat loser, so according to history, things should be looking up

Adam Shell
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NEW YORK -- A key selling point for investing in the stock market is that over the long term, the risk of owning stocks diminishes and the odds of making money jumps.

But cracks in that Wall Street marketing message became painfully visible in the just-ended 2000s -- dubbed the "Lost Decade." For the first time, the Standard &Poor's 500-stock index finished a calendar decade with a negative total return, S&P says. And that was even after the S&P rose 23.5% in 2009, its best gain since 2003.

"I've lost a bet. I've lost my keys. But I've never lost a decade -- until now," Sam Stovall, S&P's chief strategist, quipped in his "Lost Decades" report.

Indeed, a $1 investment in the S&P 500 on Dec. 31, 1999, was worth roughly 90 cents at the end of 2009 -- and that negative return includes dividend income. In contrast, investments viewed as havens, or more conservative places to park cash, delivered positive returns in the 2000s. A $1 investment in gold grew to nearly $4, according to Strategas Research Partners. And a buck invested in U.S. government bonds, arguably the world's safest investment, grew to nearly $2.

The dismal showing by U.S. stocks raises a key question on the first trading day of the 2010s: Will the lost decade serve as a bullish "launching pad" for the new decade? Or will the negative vibes from two brutal bear markets in the past 10 years and the economic damage caused by the worst financial crisis since the Great Depression set the stage for a second decade of subpar performance for U.S. stocks?

In the past, stocks have fared well after 10-year periods in which they fared poorly.

The S&P 500 has never suffered back-to-back losses in calendar decades. In the 1930s, the last decade the index bled red ink, it posted an annualized loss of 5.3%, excluding dividends, and posted a paltry annual total return, which includes dividends, of 1.0%, S&P says.

The good news: The index posted annualized total returns of nearly 9% in the '40s and 19% in the '50s.

Similarly, an analysis of the 15 worst rolling 10-year periods for the S&P 500 by The Leuthold Group found that stocks posted positive returns in the next 10 years in all 15 cases. The average annual gain: 10.7%, topping the 10% long-term average.

"In general, after bad periods come good periods," says Bob Doll, global chief investment officer of equities at **BlackRock**.

But not always. Japan's stock and real estate bubble that burst in early 1990 set Japan up for not one lost decade but two. The Nikkei stock average peaked on Dec. 29, 1989, at 38,915 but remains more than 70% below its high despite big periodic rallies.

Why do long periods of lousy stock returns tend to be followed by long periods of solid returns?

*Steep drops wipe out excesses. Jeremy Siegel, a finance professor at the Wharton School of business and author of Stocks for the Long Run, notes that the nearly 20% annualized total returns posted by the S&P 500 in the 1980s and 1990s were the best back-to- back decades ever. The losses that followed in the 2000s were the market's way of wringing out the euphoria.

"The horrible decade has wiped out all the excesses of the previous two decades and put us back on track for more normal returns," Siegel says.

*Shocks to investor sentiment are a positive contrarian sign. Jeff Kleintop, chief market strategist at LPL Financial, says stocks tend to get riskier when investor expectations are super- optimistic. On the flip side, when sentiment gets depressed, upside surprises are more likely. Why? Most investors who wanted to get out of the market have done so, paving the way for higher prices and greater demand for stocks when conditions improve.

"We began 2000 so optimistic, and valuations were so high," Kleintop says. "Now at the start of the 2010s we are very, very pessimistic."

*Sharp stock price haircuts create value. After periods in which the broad index goes nowhere, or falls more than 50% as it did in the last bear market, formerly lofty valuations come down sharply, providing cheaper entry points for investors, says Francis Kinniry, a principal at Vanguard's Investment Strategy Group.

After steep drops, "You are buying stocks at fair value or a discount to fair value," he says.

Still, Kinniry, co-author of a Vanguard paper on the "lost decade," insists that past results don't tell investors much about what comes next.

Still, there is credence in the thesis that after long periods of lousy stock performance, the conditions needed for stocks to flourish materialize.

BlackRock's Doll argues that it is improving business, economic and market fundamentals that eventually drive stock prices higher -- not just the calendar pages flipping to a new decade.

"The world economy will continue to grow," says Doll, ticking off perhaps the biggest reason he and most optimists think stocks will post average annual gains of 6% to 8% in the 2010s.

Doll's investment thesis revolves around a few key points. The first is that world growth is sustainable. The growth, he says, will increasingly be led by emerging-market economies, such as China, India, Brazil, Russia and other countries benefiting from the emergence of a new middle class with jobs, cash and the willingness to spend.

Also bolstering Doll's bullish view is the fact that a flourishing global economy will enable U.S. companies to continue growing their profits. He also expects investors who fled the stock market during the scary meltdown in early 2009, and who now have too small a helping of stocks in their portfolios, to ratchet their stock holdings back up.

Vanguard's Kinniry points to other improving conditions that suggest higher stock prices in the 2010s. He notes that the price of stocks relative to their earnings, known as the P-E ratio, has come down sharply since the 2000 peak of more than 30.

Based on analysts' expectations for 2010 earnings, the S&P 500 is now trading at 14.5 times earnings, says Thomson Reuters. And that's a shade below the long-term average of 15. The fact that yields on 10-year U.S. Treasury bonds are rising after hitting historic lows last year also suggests that the odds are good that stocks will post better returns than bonds and cash in the coming decade, Kinniry says.

Jim Paulsen, a strategist at Wells Capital Management, says: "We are one innovation away from another bull run."

Bears also have their points

But for each bullish point, there is a bearish counterpoint.

One skeptic is Tony Crescenzi, strategist and portfolio manager at Pimco. Pimco coined the phrase "the new normal" to describe its view of a financial world far less stock friendly than the go-go '80s and '90s.

"Time, in and of itself, is not a real harbinger of stock prices, and other lost decades were followed by many more years of stagnant returns," Crescenzi says. He notes that the Dow Jones industrials went nowhere between 1964 and 1982, and that after the 1929 crash the Dow didn't return to its previous high until 1954.

The ultimate drivers of stock prices are corporate profits and the willingness of investors to take the extra risk of owning stocks, Crescenzi says. But he warns that both profitability and risk-taking will be pressured this decade by long-term negative influences caused by the bursting of the credit bubble. The days of growing the economy and profits with the help of cheap, borrowed money are over due to the "reduced availability of credit and the reduced appetite for borrowing," Crescenzi says.

Another potential drag on stocks is what Crescenzi refers to as the "de-risking mentality." As the Baby Boom generation ages, investors will likely pursue more conservative investment strategies that protect savings from so-called black swan events -- improbable but high-impact occurrences such as the 2008-2009 mortgage and credit market meltdown.

As a result, stock purchases by individual investors are likely to remain tepid, as has been the case since the tech stock bubble burst in early 2000.

"If households did not return (to the stock market) after the shock they received after the bursting of the (tech) bubble in 2000, how can we expect them to return after this latest shock?" Crescenzi says.

Axel Merk, president and chief investment officer of Merk Mutual Funds, says fallout from the financial crisis and the unprecedented government intervention to help jump-start the economy will eventually spell trouble for financial markets.

"We created a launching pad into an era of instability," Merk says. The "great subsidy" from the government has propped up the housing market, but makes the "recovery highly unstable."

Merk fears the Fed will leave short-term interest rates too low for too long (they are now at a historic low of roughly 0%), causing high inflation that will harm the economy and markets.

Will recent problems linger?

Investors who see much better returns ahead are making the same mistake as those who expect a V-shaped recovery, says Michael Panzner, who writes a blog, Financial Armageddon, and is the author of When Giants Fall: An Economic Roadmap for the End of the American Era.

"They fail to grasp that the crisis-led downturn was not a cyclical event, but the first stage of a secular recalibration," he says.

Panzner believes the causes of stocks' poor performance in the 2000s -- the bursting of the housing bubble, an economy built on debt and an easy money policy from the nation's central bank -- have yet to be resolved.

Stocks, he argues, are still trading far above the single-digit P- Es that have kicked off sustainable bull markets in the past.

Panzner's biggest worry is "a hostile interest rate environment." The need for governments here and abroad to borrow trillions of dollars to fund deficits will push rates sharply higher. "The higher rates will inflict a lot of damage on the still vulnerable real estate sector and corporate bottom lines," he says.

Still, history is on Wall Street's side, says Michael Farr, manager of the Touchstone Capital Appreciation fund: "While nobody can say with any certainty what stocks will do going forward, returns following these rare periods of underperformance have been excellent. It is not unreasonable to expect long-term stock returns of 7% to 8%."

GRAPHIC, Color, Sam Ward, USA TODAY (Illustration)

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MONEY
Deflation's a threat now worth hedging against

John Waggoner
863 words
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If you're ever up at 3 a.m. watching Law & Order -- and rest assured it's on at least three channels -- you've probably noticed a theme among the ads for Snuggies, self-sharpening kitchen knives and wonder beets. Everything is at cut-rate prices.

And this isn't just a theme in commercials; prices are down everywhere.

If you're worried about inflation, you're going to be hard- pressed to find any. The scariest economic monster out there is deflation, and you should consider devoting at least part of your portfolio to hedging against it. Investors have focused on inflation in recent months, mainly because of the government's eye-popping deficit figures. The federal budget deficit for fiscal year 2009, which ended Oct. 1, was $1.4 trillion, far larger than any preceding yearly deficit. The deficit is the yearly amount that the government overspends its budget. The total government debt is almost $12 trillion, including intergovernmental holdings for Social Security.

The argument for inflation is that so much borrowing will tempt the government into running the printing presses, in effect paying off the debt with watered-down currency. The dollar's decline in value against other currencies, such as the euro, is one indication of how deeply investors worry about future inflation.

Inflation may rear its ugly head eventually, but it's sure not happening now. The consumer price index, the government's main gauge of inflation, fell 1.3% the 12 months ended in September. "Inflation is an unlikely problem anytime soon," says John Lonski, chief economist for Moody's Investors Service.

The CPI may be headed for further declines, Lonski says. About 40% of core CPI -- which excludes the volatile food and energy sectors -- consists of rents or rental equivalents, which reflect the cost of shelter. But there's such an excess supply of rental units that further declines in rent are quite likely.

Real estate prices have stabilized a bit, and even risen in some areas, but much of that is because of the government's $8,000 tax credit for first-time home buyers, which Congress extended and expanded Thursday. The tax credit is, to some extent, simply a discounting of real estate prices. Similarly, the "cash-for- clunkers" program was a government-subsidized price cut for cars.

Lower prices, however, are simply a symptom of the real driving force behind deflation, which is lower incomes and higher unemployment. People aren't going to pay higher prices for anything if they think their incomes will shrink, or if they think they might be unemployed. Right now, they have good reason to believe both. The unemployment rate was 9.8% in September, and 5.4 million people have been unemployed for 27 weeks or more -- 35.6% of the unemployed population.

Those kinds of dismal numbers have a profound effect on consumer psychology. In the University of Michigan's survey of consumer sentiment, more people think their incomes will fall in six months than think they will rise. The trend started in March 2008 and hasn't been seen before in the survey's history, which stretches back to January 1978.

Robert Prechter, author of Conquer the Crash: You Can Survive and Prosper in a Deflationary Depression, thinks the effects of a deflationary mind-set can't be overcome by stimulus programs. "You can't change the course of social psychology," Prechter says. If you're terrified of deflation, then your best investments now are Treasury bills, Prechter says. Even though they yield next to nothing, they preserve your capital. And while the government is deeply in hock, it's likely to be the last borrower left standing. The U.S. still has sterling credit -- which is why T-bills yield next to nothing.

High-quality interest-bearing debt is also a good deflationary investment. After all, each interest payment will have more buying power as prices fall. Securities backed by the Government National Mortgage Association have the full backing of the U.S. government -- and they yield more than T-bills. The top-performing GNMA funds are in the chart.

A side note: The returns for Putnam U.S. Government Income are correct, and Putnam says the fund is 70% in GNMA securities. Nevertheless, it's very doubtful that any bond fund that outperforms its peers by 20 percentage points will continue to do so for any length of time.

John Waggoner's column appears Fridays. E-mail: jwaggoner@usatoday.com. Follow him at www.twitter.com/johnwaggoner.

TEXT OF INFO BOX BEGINS HERE

Top-performing GNMA funds

Fund, ticker Total return 12-mo. yield

2009 5 yrs.

Putnam US Government Income Trust A, PGSIX 26.2% 37% 4.24%

Payden GNMA Fund, PYGNX 6.4% 31% 4.70%

Fidelity Ginnie Mae Fund, FGMNX 6.9% 31% 4.23%

Vanguard GNMA Fund Investor, VFIIX 5.3% 31% 4.16%

BlackRock GNMA Portfolio Investor A, BGPAX 5.6% 30% 3.64%

Average GNMA fund 7.9% 28% 3.95%

1 -- Dividends, gains reinvested through Wednesday. Yield as of Oct. 31.

Source: Lipper

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MONEY

Despite recent deals, mergers aren't taking off ; Activity is still down 23% from this point in 2008

Matt Krantz
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Berkshire Hathaway's $26.3 billion takeover offer Tuesday for Burlington Northern Santa Fe, just a day after Stanley Works said it's buying Black & Decker, might give a false impression that the mergers-and-acquisitions market is roaring back.

Despite the banner headlines, dealmaking is still stuck in the post-credit-bubble malaise and isn't likely to rival its 2007 heyday anytime soon.

This year, there've been 5,786 deals worth $619.8 billion in the U.S., Dealogic says. That value of announced deals is 37% below where it was this time last year and 55% below its level in 2007. And the number of deals is down 23% from this point in 2008 and 36% from 2007, Dealogic says.

Even though Warren Buffett's Berkshire Hathaway is making its biggest deal ever, the news couldn't stop the Dow Jones industrial average from slipping 18 points to 9772.

Still, there is no denying the M&A market is coming back alive, and the gains in other railroad stocks Tuesday show traders are speculating about the next deal. "M&A is coming back, but it's certainly not raging back," says Ken Henderson, partner at law firm Bryan Cave. "It's going to take awhile."

M&A observers are hopeful the market is slowly thawing because of:

*Rising confidence by CEOs that it's time to go beyond just cutting costs. A theme during third-quarter earnings season was investors' demands for companies to start boosting revenue. Companies are expected to end a string of revenue declines this quarter with 3% growth, S&P says.

CEOs are looking at acquisitions as "one tool" they have to boost revenue by adding products, services or geographies, says Steve Krouskos, an M&A expert at Ernst & Young.

And the fact stock prices and credit markets have stabilized, Krouskos says, gives CEOs greater confidence to take on big deals.

*Broad industry participation. Most M&A activity is being driven by companies looking to buy rivals that have something they're lacking, says Mike Angell of M&A tracker FactSet Flashwire.

Companies on the buyout prowl are coming from a variety of industries. No single industry has accounted for more than a quarter of all the year's number of deals in the USA, says Thomson Reuters. Health care companies have accounted for 21% of the deals, followed by industrials at 15% and financials at 14%.

*Financing is tough, but possible. Companies are finding creative ways to finance deals, which wouldn't have been possible months ago, says John Babala at law firm Wildman Harrold Allen & Dixon. Non- financial Standard & Poor's 500 companies are also sitting on a record pile of $702 billion in cash, as of the end of the second quarter, S&P says.

"With more confidence comes the willingness to part with some cash (for M&A)," Henderson says.

TEXT OF INFO BOX BEGINS HERE

Top five acquisitions

2009's biggest U.S. takeover offers (in billions):

Target Offer Acquirer

Wyeth $68.4 Pfizer

Schering-Plough $41.1 Merck

Burlington Northern $26.3 Berkshire Hathaway

Barclays Global $13.5 **BlackRock**

Liberty Entertainment $12.7 DirecTV

Source: Dealogic

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BONUS
What's an investor to do?

Adam Shell
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NEW YORK -- A look back at history shows that a good time to invest in the stock market is when a shrinking economy is on the path to recovery. In fact, in the post-World War II era, stocks have posted gains 90% of the time in the six- and 12-month periods after the end of a recession, according to Ned Davis Research. On average, stocks in the Standard & Poor's 500-stock index are up 14.4% a year after an economic downturn is declared dead.

Those are pretty comforting statistics. But that assumes that the recovery is real, robust and sustainable. The problem: There are plenty of economists, analysts and money managers on Wall Street who question whether the budding recovery has real legs. To complicate matters further, stocks have already rallied 54% since bottoming on March 9.

And therein lies the quandary for investors: How to invest now for an economic recovery that has more question marks than answers. To help guide investors through this uncertain time, USA TODAY's Adam Shell has sought the advice of a handful of some of Wall Street's top players.

A head-spinning turn -- up!

Richard Bernstein, Richard Bernstein Capital Management

Despite talk of a stock pullback after a big six-month run-up, the outlook for stocks "might be better than people think," says Richard Bernstein, the former chief strategist at Merrill Lynch who recently opened his own investment firm.

And that bullish outlook says a lot, considering that Bernstein has been among Wall Street's most cautious strategists the past few years. "Even a little bit of economic improvement will set the stage for a big improvement in the stock market," he says.

What's working in stocks' favor? A better profit outlook for U.S. companies as business conditions improve and consumer confidence rises. A boost to economic growth next year from billions of dollars in still-unspent government stimulus funds.

"The argument about whether the fiscal stimulus is working or not is silly," says Bernstein. "Most of the stimulus is in the pipeline and has yet to be spent."

As a result, the economy is on the cusp of a "blow-out, gangbuster quarter" where corporate profits come in way higher than expectations.

Bernstein also stresses that it is very rare for stocks not to get a huge rebound after a catastrophic decline. "We are bound for a big snapback," he says.

Staircase to profits

Abby Joseph Cohen, Goldman Sachs

While this economic recovery will be muted compared with prior ones, because of a more cautious consumer and an anemic job rebound, the recovery will be sustainable, predicts Abby Joseph Cohen, a senior investment strategist at Goldman Sachs. "We don't expect a double dip back into recession," she says, noting that there is enough pent-up demand in certain sectors of the U.S. economy and adequate strength from abroad to avoid a relapse.

Nor does she expect the stock market to give back the big gains since the March 9 bear market bottom. The market, Cohen says, will continue to rise in a "staircase" pattern in which stocks rally, pause, then rally more.

Right now, after a 54% surge for the Standard & Poor's 500 index since early March, investors await more information about future business conditions. The incoming data, she predicts, will confirm the strength of the rally. "The next move will be up, not down."

She says both the economy and corporate profits will continue to grow. Profit reports in the final two quarters of 2009 will appear robust compared with very depressed earnings a year earlier. "Thanks to easy comparisons, profit numbers from companies ... will look better than the economic numbers," says Cohen.

A return to riskier investments

Brian Rogers, T. Rowe Price

As nightmares over the next Great Depression fade and investor confidence improves, a shift from safe assets to riskier ones, such as stocks, will take shape.

And that powerful psychological shift will push the stock market higher over the next year or two, says Brian Rogers, chief investment officer at T. Rowe Price.

Fueling the recovery will be the unprecedented amount of government stimulus that is bound to spark an economic bounce-back, albeit a slow and gradual one. "As Warren Buffett always says, 'Recoveries always follow downturns.' It always happens," says Rogers.

The key is confidence in the future. "When investors worry less, psychology improves and money flows back into riskier asset classes," says Rogers, noting that money is finally moving out of low-risk money market funds and back into stocks.

Despite a gut-wrenching decline in the past bear market that tested the beliefs of the most-committed long-term investors, Rogers says the principles of investing remain intact.

"The financial environment might have changed, but investors should do what they have always done," says Rogers. "They should invest in good companies run by smart people that are selling at attractive prices."

'Less bad' news won't cut it

Bob Doll, **BlackRock**

The mega-stock rally that came out of the ashes of the worst economic downturn since the Great Depression was driven by "less bad" economic news. But if stocks are to continue their so-called recovery rally and push higher, investors must start hearing "good news," says **BlackRock**'s Bob Doll.

Even so-called good news doesn't mean investors should expect the typical 7% growth after recessions. The economy is likely to grow at half that pace, says Doll.

That doesn't mean investors should shun stocks and load up on safer assets such as cash and bonds. But don't load up on all the "back from the dead" stocks that rallied the most in the early stages of the monster rally that began in early March.

"Our guess is you need a more mixed portfolio," says Doll. "You want to be involved, but you want a diversified portfolio."

Doll says investors should own so-called cyclical stocks, such as energy, that will do well in upturns, as well as defensive plays such as health care stocks, and companies with good growth potential, like those in the technology sector.

"The bottom line is, if you agree we are recovering, you have to own risk assets," says Doll.

When 'sugar high' wears off, watch out

Mohamed El-Erian, Pimco

The stalled economy has been boosted by billions of dollars in government money, a cash infusion that Pimco CEO and co-chief investment officer Mohamed El-Erian refers to as an artificial stimulant, or "sugar high."

El-Erian's concern centers around what happens to the economy when it comes down from its sugar rush.

He equates all the stimulus with jumper cables that are used to get a disabled car running again. "Can the car (i.e., economy) keep running once the cables are off?" The answer: "We just don't know," he says.

El-Erian says economic growth will enjoy a bounce in the third and fourth quarters of 2009, thanks to the government stimulus and the rebuilding of depleted inventories. But he warns that the economy will face stiff headwinds in the form of tight credit and tight-fisted consumers who are likely to save more and spend less.

He expects U.S. growth to be subpar compared with past rebounds. GDP could slow to 2%, down from trend growth of 3%. He calls this the "new normal." As a result, "It's time for investors to be conservative," he says.

El-Erian advises folks to seek out assets that have suffered big dislocations and are selling cheaply due to the economic storm. The key, he says, is to find investments that will fare well in the new world of slower growth.

Signs that the recovery is for real

How will you know when the risk of an economic relapse, or double- dip recession, is no longer a threat -- and that the road to recovery is clear? Here are some signposts to monitor:

Jobs

About 6.9 million jobs -- and paychecks -- have been lost since the end of 2007, the Department of Labor says. Early signs of job creation could signal that companies are done firing and are looking to hire -- and that the cash flow of everyday Americans is improving. A substantial drop in the number of weekly initial jobless claims below 500,000 (last week 550,000 filed for unemployment insurance) would be another key clue that the job market is improving.

The stock market

If investors flock back to riskier assets such as stocks, while fleeing havens such as low-yielding CDs and money market funds, it would send a clear message that confidence is restored.

Retail sales

After rising in May and June, sales at the nation's retailers slid 0.1% in July, disappointing analysts who expected a third- consecutive month of gains. The weakness suggests consumers, hurt by falling housing prices and a weak job market, are still in defensive mode. Any signs that retail sales are on a sustainable uptrend would signal that the process of consumers' reducing debt and boosting savings has dissipated.

Corporate profits

U.S. companies topped Wall Street profit expectations in the first two quarters of 2009. But most of the improvement came from cost and job cuts. If the missing link -- revenue growth -- picks up, it would confirm that the recovery is on track.

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Investing roadmap

How can you profit from a rebounding economy? Here are some smart money plays from some of Wall Street's smartest players:

Mohamed El-Erian

Pimco

*Hold fewer U.S. stocks and more foreign shares. It is a way to profit from faster growth abroad, in places like China.

*Protect against rising inflation. All that spending by Uncle Sam boosts the odds of a surge in the inflation rate in coming years. Consider TIPS, or U.S. Treasury bonds that go up in price when inflation rises. Utility stocks and commodities are also good inflation hedges.

*Insure against disaster. Big helpings of riskier assets make sense in a stable world but not in uncertain times. To protect against steep sell-offs, investors must hold a "higher percentage of safe assets."

Abby Joseph Cohen

Goldman Sachs

*In a play on a global economic recovery (Goldman Sachs expects global growth to clock in at 4% in 2010), technology, commodity and materials stocks should benefit most.

Richard Bernstein

Bernstein Capital Management

*Your portfolio should have a normal weighting of stocks based on your age and risk tolerance. Not too big or too small a helping of stocks.

*Invest in America, not China. Sure, China is viewed as the world's new growth engine. The problem? A credit bubble is brewing there. "There's tons of risk."

*For diversification, try U.S. Treasury bonds. Despite yields near historic lows, Bernstein says, government debt is a good risk reducer because returns on these bonds have had an inverse correlation with stocks. In contrast, most other asset classes, such as oil and emerging market stocks, have been moving in lockstep with stocks, which means if stocks fall in value, these other investments will, too.

Brian Rogers

T. Rowe Price

*Play the rebound by buying stocks of companies that will sell more stuff as the economy picks up steam, says Rogers. So-called cyclical plays, such as home improvement retailers (Home Depot), oil companies (Chevron) and diversified manufacturing companies (3M) should get a lift.

Bob Doll

BlackRock

*Build a diversified portfolio that includes some cyclicality (energy), some defense (health care) and some growth (technology).

*Don't load up on cash and bonds or back-from-the-dead stocks.

GRAPHIC, Color, Alejandro Gonzalez, USA TODAY (illustration); PHOTO, Color, 2005 USA TODAY photo; PHOTOS, Color, Brendan McDermid, Reuters (2); PHOTO, Color, Robert Deutsch, USA TODAY; PHOTO, Color, Goh Seng Chong, Bloomberg News

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BONUS
What are the best picks? ; Things are looking up, so there are many routes to a winning portfolio

John Waggoner
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English

The investment climate in the next 12 months will be better than it has been since the start of the credit crisis last year. Of course, that's a bit like saying the dishes won't rattle as much now that the earthquake is over.

One year ago, the credit markets were nearly collapsing, the stock market was plunging and government officials fretted about the next Great Depression.

Fortunately, the banking system didn't collapse, and we don't live in a world of bread lines. The Standard & Poor's 500-stock index has soared 54% from its March 9 low; interest rates have fallen; and the money markets have thawed. "All the predictions were too dire," says Robert Doll, chief investment officer at **BlackRock**. "The world wasn't going to end as we know it."

But few observers are jumping up and down about the prospects for the next 12 months. Even though inflation will remain low, interest rates are likely to rise, and so are taxes. The value of the U.S. dollar will probably fall on the international currency exchanges. And commercial real estate could crumble.

In short: A bull market that brings us to all-time highs seems as improbable as, well, the next Great Depression. The odds seem stacked for a middling stock market and bond market. But don't rule anything out: "The spread of possible outcomes is wider than normal," Doll says. For investors, that means it's a good time to diversify broadly -- not just in stocks and bonds, but in money funds, real estate and possibly even commodities.

Bonds

Because the bond market is the most sensitive to the economy, we'll start there. After all, it was the bond market that sent stocks and the rest of the financial markets reeling last year.

The next 12 months should be good for bonds, because the bond market is happiest when the economic outlook is tepid-to-grim.

To most observers, the economic outlook is tepid. Bill Gross, chief investment officer at bond powerhouse Pimco, thinks that economic growth should flatten in 2010 as the effects of the government stimulus fade. "We sense a move back to zero growth unless the employment situation gets better," Gross says.

And the employment situation isn't very good. The unemployment rate, now 9.5%, should peak at 10.3% by March, says John Lonski, chief economics for Moody's Investors Service. Unemployment is a lagging indicator -- companies don't start hiring again until the recovery is well underway -- but he doesn't see the jobless rate falling quickly. "It won't be a V-shaped recovery," Lonski says.

Moody's says that the default rate among companies that issue high-yield, high-risk bonds will peak in November at a postwar high of 12.7%. The all-time high, set in the Depression, was 15.4%, Lonski says.

All of which spells a good environment for bonds -- with two big caveats:

*Higher yields. Bond prices fall when interest rates rise. And a big supply of Treasury bonds, combined with fewer buyers, could spell higher rates, Gross says. The Chinese, who are among the largest buyers of Treasury securities, are buying fewer Treasuries. And the Federal Reserve's program of buying Treasuries will end soon, too. "Almost by definition, yields will be higher," Gross says. "Two significant buyers of Treasuries will be disappearing."

*High prices. The bond market has already had a huge rally: The high-yield bond market has soared 50% since March. Junk bonds yield about 8% more than comparable Treasury securities. "Does that compensate for a 12% default rate? Maybe, but just barely," Gross says.

Average investors should look for high-quality bonds that mature in two to five years, Gross says. And, he says, Treasury securities really aren't such a bad deal -- especially considering that the consumer price index, which measures inflation, has fallen by 2.1 percentage points the past 12 months.

Stocks

A slow-growing economy doesn't seem like the best environment for stocks, but it's not the worst, either.

"When the market got blasted last year, it was discounting the recession," says Phil Foreman, manager of the Principal Capital Appreciation fund. The market's recent jump has forecast the end of the recession -- but just what the recovery will look like is still up in the air, Foreman says. "If we have slow growth and low inflation, the stock market can do all right," he says.

Foreman, whose fund has outperformed 97% of its peers the past decade, says the government's stimulus package is starting to take hold. "The government is spending a lot of money in certain areas, and a lot of it hasn't been spent yet," he says. But in the second half of this year and the first quarter of next, some industries should start feeling the effects of the stimulus.

Which ones? The stimulus aims to rebuild the USA's infrastructure and reduce energy consumption -- so companies that would benefit from mass-transit projects would be likely beneficiaries, Foreman says. Another industry that should profit from the stimulus: financial services. "People are saving more, and that's a theme that will continue," Foreman says.

The big question: Will the stock market rally take the S&P 500, which has bounced between 677 and 1565 for a decade, to new heights? **BlackRock**'s Doll doesn't think so. "I don't think I see 1550 (on the S&P 500) before another intervening bear market and recession," Doll says. Eventually, he says, the Federal Reserve will have to raise interest rates. And taxes will probably rise, too, because of the growing federal debt. Rising rates and higher taxes rarely fuel a bull market in stocks. "I'm guessing we'll see 1250 on the S&P 500 before this move is over," Doll says.

Nevertheless, Doll thinks there will be some industries that fare better than others. He likes energy, which will do well if the economy starts growing, and health care as a defensive play. For those looking for growth, technology stocks should fare well even in a lackluster economic environment.

Real estate

Real estate has long been used as a diversification play: After all, commercial real estate doesn't march in lockstep with either stocks or bonds. For most investors, the best way to diversify into commercial real estate is through real estate investment trusts, or REITs. These companies invest in office buildings, apartments, shopping malls and other commercial properties and pass nearly all of their income on to investors through dividends.

If you're thinking of diversifying into real estate, however, you have some time to think about it: The outlook for the next 12 months or so is unrelentingly grim.

"We think we'll be moving along the bottom in 2010, or that some additional stress to be realized will show itself," says Ed Casas, senior managing director of Navigant Capital Advisors.

Why real estate remains distressed:

*Commercial real estate delinquency rates are at levels not seen since 1994, and rising. Values have fallen 49% in San Francisco, 43% in Phoenix and 44% in New York City.

*Lenders aren't lending. Because delinquency rates are rising, loans are exceptionally hard to find. Casas' assessment of the real estate loan market: "It's moribund."

*Unemployment remains high and consumer confidence is low -- both of which mean that demand for new office buildings and malls will stay low.

Commodities

Commodities -- gold, corn, pork bellies -- have long been promoted as a good diversification play for investors. After all, rising princes are inflationary, and stocks and bonds loathe inflation. And investors can now choose among dozens of exchange traded funds that track the prices of everything from steel to water.

Unfortunately for those investors, inflation is dead. Commodity prices have fallen about 30% the past 12 months, because demand has fallen -- and not just here, but in China and India as well.

Even if the economy breaks out of its slumber tomorrow, you have plenty of time to add commodities to your portfolio. Demand for raw materials heats up after companies have sold off their inventories and factories are working at capacity. Currently, factory capacity utilization in the U.S. is at 68.5%, vs. its long-term average of 80.9%. Mines are running at 81.7% of capacity, vs. 87.6% from 1972- 2008.

If you decide to add commodities to your portfolio, stick with funds that track a broadly diversified commodity index, rather than a single commodity. You'll get greater diversification and less volatility.

If you're concerned about the falling value of the dollar, you might also consider adding gold to your portfolio. Gold prices tend to rise when investors lose faith in printed money. But be careful: Gold is hovering near its all-time high. Most experts say you should keep no more than 5% of your portfolio in gold, and that you should rebalance your holdings periodically to make sure it doesn't become too large a part of your portfolio.

Money funds

What about money market securities, or cash? Right now, keeping cash on the sidelines will cost you, too. The average money market fund yields 0.06%, or 6 cents for every $100 you invest.

The good news is that the money market has stabilized: The short- term IOUs that money funds buy and sell are the lifeblood of the financial system. Had Bear Stearns or Lehman Bros. been able to get short-term loans in the money market, they might well be around today.

The modest government insurance on money funds, covering all assets held before Sept. 18 last year, ends Friday.

And short-term rates are unlikely to rise until late in 2010, Moody's Lonski says. "The Fed won't raise rates until August 2010 at the earliest, and if it does, the fed funds rate won't be any higher than 1% in 2010," he says.

Savers can earn a bit more money by moving to short-term bank CDs or money market accounts. But if you want to play it safe in this environment, you'll need to accept lower yields.

Reasons to be cheerful

Despite all the gloom, investors have reason to be optimistic in late 2010 and beyond. As corporations and individuals pay down their debts, they will have more money to spend -- and that translates into a more robust economy.

Corporations that repay debt now, for example, will have more cash on hand later to grow and expand. And even if the Fed does push rates higher, a 1% fed funds rate is exceptionally low by historical standards.

"We are in a recovery, the recession does seem to be ending, and there's a ton of cash on the sidelines getting a zero percent return," says **BlackRock**'s Doll.

The stock market is no longer fretting about whether corporations will survive, but whether they will grow. And that, at least, is usually a good sign for the investment climate.

GRAPHIC, Color, Alejandro Gonzalez, USA TODAY (illustration);
GRAPHIC, Color, Karl Gelles, USA TODAY, Source: Bloomberg (line graphs)

Document USAT000020090917e59h0000m

MONEY

Collapse upended economic supports ; Investment bank's failure nearly triggered meltdown

Adam Shell
1,865 words
11 September 2009
USA Today
USAT
FINAL
B.1
English

NEW YORK -- The fallout was fast and frightening, and will reach far into the future.

Almost 6 million lost jobs. A 5,000-point Dow plunge. The government bailing out cash-starved banks. General Motors and Chrysler declaring Chapter 11. The unemployment rate doubling to almost 10%. Consumers getting $4,500 handouts from Uncle Sam to buy a car. Talk of a 1930s-style depression.

To modern-day Wall Street historians, these bizarre events mimic the other-worldly feel of a Ripley's Believe It or Not episode. But all those unthinkable occurrences made news in the past year. They all tie back to Sept. 15, 2008, the day Wall Street titan Lehman Bros. filed for bankruptcy. The collapse of the investment bank was so shocking it triggered a financial tsunami of such size and scope that it was compared to the Great Depression.

And while the events of that panic-drenched day are probably not etched into peoples' memories as are the "I remember where I was" vividness of the bombing of Pearl Harbor, the assassination of JFK, the space shuttle Challenger explosion or the Sept. 11 terrorist attacks, it will be remembered as the day Lehman's demise almost triggered a global financial meltdown.

"Lehman's bankruptcy will forever be synonymous with the financial crisis and (resulting) wealth destruction," says Paul Hickey, founder of Bespoke Investment Group.

The legacy of Lehman's fall is still playing out. Investors and consumers are adapting to a new world that many analysts warn will be far less ebullient than the high-risk, credit-fueled system that came crashing down a year ago in a rubble of bad loans.

"We are on a bumpy journey to a new destination," says Mohamed El- Erian, CEO of giant money manager Pimco. "The new destination will look much different than where we came from."

In the years leading up to the Lehman collapse, the economy was artificially fueled by cheap money that made it easy for anyone who wanted a loan to buy a house, a car or expand a business to get one. Before the housing crash, many Americans treated the rising value of their homes and other investments as a substitute for savings. But the $14 trillion in household wealth destruction caused by plunging home prices and the worst stock swoon since the 1930s has wiped away that false sense of financial security for a generation of Americans.

Confidence plummets

Trust in the stability of the financial system took a major hit when, after having hinted that it would not let any major financial institution fail, the government did a 180-degree turn and refused to bail out Lehman, says John Garvey, head of the U.S. financial services practice at PricewaterhouseCoopers.

"That shook market confidence to its core and caused people to believe the whole system could blow up," says Garvey. "I don't think anyone fully understood the impact of confidence and what it means to the proper functioning of the system."

The collapse in confidence was best illustrated in the banking system, where banks were unwilling to lend money to each other for fear of not getting paid back, a dramatic shift that froze credit markets and caused borrowing rates for banks and businesses to skyrocket.

El-Erian ticks off other ways in which the world has been altered by the banking crisis:

*Banks and other financial institutions, after being battered by the real estate bust caused in large part by their loose lending standards, will now be subject to greater government regulation. The financial sector must also operate with far less borrowed money, or leverage. "That means there will be less credit available," El- Erian says. "The banking sector will be a shadow of its former self."

*The federal government's role in the everyday workings of the financial system, which rose to unprecedented levels during the financial crisis, will remain elevated. The government must still unwind or exit the programs it's put in place in the past year in an effort to stabilize the system and jump-start the economy. The risk is that the transition will be handled poorly, creating problems such as an economic relapse or jumps in interest rates and inflation, he says.

*The bottom line is that the U.S. economy will likely grow at a slower pace than it has in the past. Sapping growth will be the combination of tighter credit and the need for consumers to save more money each month to offset the big losses they suffered from plunging real estate values and lost jobs.

"In the U.S., the speed limit for economic growth will come down from 3% to 2%," says El-Erian. That slowdown, he adds, has many negative implications, such as reduced retail sales, fewer jobs and skimpier profits at U.S. companies.

Not all gloom and doom

But not everyone on Wall Street thinks the financial crisis has radically changed the world of money. James Paulsen, chief investment strategist at Wells Capital Management, says the economic downfall was made worse by scary warnings about another depression by high-ranking government officials, including Presidents Bush and Obama, Federal Reserve Chairman Ben Bernanke, Treasury Secretaries Henry Paulson and Timothy Geithner, as well as members of Congress. Many investment strategists argue that the sharp drop in the Standard & Poor's 500-stock index from its pre-Lehman level of around 1250 to its bear market low of 676.53 was overdone, as investors incorrectly priced in a depression. The S&P closed Thursday at 1044.

"What made it so petrifying was that our leadership was on the airwaves talking about the threat of a depression," Paulsen says. "If they wouldn't have done that, I wonder if things would have gotten as bad. The tagline I put on this calamitous period is: 'The depression that wasn't.' "

It's too early to say that consumer spending won't bounce back to more normal levels, Paulsen says. He stresses that too much is being made of strapped consumers and a shift from free-market capitalism in the U.S. "What investors aren't focusing on is the emerging consumer base in Asia and the breakout of capitalism around the globe."

Not the same

Still, other analysts say that there are many other ways in which the Lehman failure is a potential game-changer in the way consumers view money and investors weigh investments:

*Splurging consumers dialing back. The free-spending ways of consumers have been interrupted. It's not hard to figure out why. Housing prices in the nation's 20 biggest cities have fallen 31% since the July 2006 peak and 12% since Lehman's bankruptcy, based on the S&P/Case-Shiller Home Price Index.

Couple that with a weak job market and a stock market still down 33% from its October 2007 peak, and it's no wonder consumers are spending less and saving more.

"Animal spirits of consumers have not come roaring back," says Rod Smyth, chief investment strategist at Riverfront Investment Group. The unwillingness of consumers to spend is due largely to huge debt loads. "That necessitates more savings," he adds.

The consumer savings rate, which turned negative in the years leading up to the financial crisis, shot up to almost 7% in May, the Commerce Department says. This closely watched metric measures savings as a percent of disposable income. In July, the most recent reading, it dipped to 4.2%. This return to old-fashioned saving, however, acts as a depressant on economic growth at the very time consumption is needed most.

*Once-aggressive investors turn conservative. Investors who once chased big returns are now more concerned with protecting their money. "At the retail level, investors have been slow to jump back into the stock market," Smyth says.

A 57% drop in stock prices from the 2007 peak, coupled with homes now worth tens of thousands of dollars less, left investors feeling burned.

As a result, many investors in search of a good night's sleep are parking their money in safe places, such as certificates of deposit and money market funds, even though they're getting little, if any, return. According to data compiled by the Investment Company Institute and the Federal Reserve, there is now $9.3 trillion sitting in cash or cash-equivalent accounts despite the average yield of 0.98% on a one-year CD and 0.06% on money market funds.

The more money consumers direct to low-yielding investments, the more saving they will have to do to make up for the smaller investment returns.

"My sense is, individuals will be more sensitive to building their nest eggs via savings as opposed to speculation," says Bob Barbera, chief economist at ITG.

*Days of easy money are a thing of the past. It's not as easy to get a loan these days. Remember those 0% introductory offerings for credit cards? Or those no-money-down mortgages banks dangled in front of potential home buyers -- even those with limited means? They're a thing of the past.

"In the current environment, lenders are looking for reasons to say no, not yes," says Greg McBride, analyst at Bankrate.com. "Lenders have become increasingly selective as to who gets credit and at what price."

Credit card issuers are also getting stingier. Many banks are scaling back credit limits, closing unused credit lines and raising rates on borrowers, even those with good track records of paying on time. Tighter credit reduces consumption, which places a drag on the economy.

*Employment picture turns cloudy. The U.S. economy is undergoing structural changes. Many former job-generating businesses, such as the auto industry, basic manufacturing, financial services and traditional media such as newspapers are not likely to generate the number of jobs they once did.

"The employment situation has changed," says Richard Bernstein, founder of Richard Bernstein Capital Management.

A consolidation in the retail sector is underway, which means fewer stores and jobs.

Many jobs simply won't come back, adds Abby Joseph Cohen, strategist at Goldman Sachs. "Many workers will need to be retrained and find some other line of work."

And it is likely to take longer than usual for the jobs that are coming back to do so, adds McBride of Bankrate.com. "This may well be the mother of all jobless recoveries," he says.

No doubt, Lehman's downfall was a watershed event.

"It almost seemed like the economy, which was kind of hanging in prior to the Lehman failure, entered recession a day after the bankruptcy filing," says Bob Doll, global chief investment officer of equities at **BlackRock**. "As a result, the stock market is still a bunch lower than before, and the size of the economy is also a lot smaller. Those are important aftereffects that will take time to work through."

GRAPHIC, Color, Adam Shell and Jim Sergent, USA TODAY, Source: CSI (line graph); GRAPHIC, B/W, George Petras, USA TODAY, Source: USA TODAY research (bar graph); PHOTO, Color, Bloomberg News

Document USAT000020090911e59b0000l

MONEY
Largest stock funds

713 words
6 July 2009
USA Today
USAT
FINAL
B.4
English

Fund (see glossary)

Total return

Q2

2009

5 yrs.

American Funds Gro A (XG) 16.7% 12.1% 3%

Vanguard T Stk Idx Inv (XC) 17.0% 4.4% -8%

Vanguard 500 Index Inv (SP) 16.0% 3.2% -11%

American Funds EuPc A 22.3% 12.6% 34%

American Funds CIB A 13.2% 3.5% 18%

American Funds CWGI A 19.5% 7.0% 26%

SPDR Trust 1 (SP) 15.9% 3.2% -11%

American Funds Inc A 12.3% 3.3% 5%

Vanguard Instl Indx Inst (SP) 16.0% 3.3% -11%

American Funds ICA A (LC) 15.3% 5.6% -3%

Fidelity Contrafund (LG) 13.0% 5.7% 12%

American Funds Wash A (LV) 13.0% -2.0% -11%

American Funds Bal A 11.7% 4.0% unch.

Franklin Cust Inc A 18.8% 12.9% 11%

Vanguard Wellington Inv 13.1% 5.1% 18%

American Funds FInv A (LC) 17.1% 9.2% 10%

American Funds NPer A 18.4% 10.0% 17%

SPDR Gold (AU) 1.9% 7.8% NA

Dodge & Cox Stock (LV) 23.1% 4.8% -13%

Fidelity Dvsd Intl 22.8% 8.3% 13%

Vanguard Windsor II Inv (LV) 17.8% 2.6% -7%

iShares MSCI EAFE Idx 25.5% 7.9% 12%

Davis NY Venture A (LC) 21.1% 6.4% -8%

iShares MSCI Emerg Mkt (EM) 31.6% 31.8% 96%

Fidelity Gro Company (XG) 15.9% 12.9% 6%

Dodge & Cox Intl Stock 33.4% 16.1% 24%

BlackRock Gl Alloc A (GX) 12.1% 6.2% 39%

Hartfd Am Gro HLS IB (XG) 18.4% 12.8% NA

Vanguard Primecap Inv (XC) 14.1% 7.9% 8%

Hartfd Am G-I HLS IB (LC) 16.0% 7.7% NA

Fidelity Magellan Fund (LG) 19.1% 15.9% -16%

Fidelity Low-Prcd Stk (MC) 21.6% 12.0% 8%

Fidelity Sp US Eqty Inv (SP) 16.0% 3.2% -11%

Vanguard Tot I Stk Inv 27.3% 10.8% 21%

Fidelity Balanced 13.6% 8.6% 8%

Harbor Intl Inst 26.7% 7.6% 37%

Vanguard Health Care Inv 10.6% 1.8% 16%

iShares S&P 500 Index (SP) 15.9% 3.2% -11%

Fidelity Equity-Inc (EI) 20.6% 4.5% -16%

T Rowe Price Gro Stk (LG) 14.9% 15.1% -4%

First Eagle Global A (GX) 14.5% 5.0% 42%

American Funds AMCP A (XC) 18.6% 12.6% -8%

Fidelity Freedom 2020 15.6% 8.4% 3%

Fidelity Puritan 12.8% 7.7% 4%

Templeton Growth A 20.4% 4.9% -11%

Vanguard EM St Id ETF (EM) 34.2% 34.3% NA

Vanguard Md-Cp Idx Inv (MC) 18.4% 8.3% -2%

T Rowe Price Eq Inc (EI) 19.4% 1.1% -8%

Dodge & Cox Balanced 18.9% 6.6% -5%

Hartfd Cap Appr A (XC) 24.2% 15.8% 6%

PowerShares QQQ Trust 1 (XG) 19.4% 22.2% -1%

Mutual Shares Z (XV) 17.1% 5.4% -3%

Oakmark Eqty & Inc I 10.4% 3.7% 22%

American Funds SMCP A 28.1% 20.3% 15%

American Funds Mut A (XV) 13.4% 3.8% -2%

Ivy Asset Strategy A (FX) 2.7% 6.2% 85%

Vanguard Euro Stk Inv (EU) 26.3% 5.1% 13%

Mutual Gl Discovery A 9.6% 7.6% 42%

Vanguard Gr Indx Inv (LG) 15.6% 10.7% -8%

Pimco All Asset Inst (FX) 12.6% 9.7% 24%

Thornburg Intl Val I 22.9% 9.9% 40%

Vanguard Wellesley Inv 9.4% 2.1% 20%

Vanguard Sm-Cp Idx Inv (SC) 24.1% 7.4% -4%

Fidelity Sp 500 Ix Adv (SP) 16.0% 3.2% NA

Columbia Acorn Fund Z (MG) 20.9% 9.8% 5%

Eaton Vance LC Val A (LV) 12.2% -3.7% 3%

T Rowe Price MC Gr (MG) 17.8% 16.5% 11%

Vanguard Intl Gro Inv 27.0% 14.0% 21%

Fidelity Freedom 2030 17.4% 7.9% -2%

Vanguard Windsor Inv (XV) 18.1% 7.1% -16%

Van Kampen Eq & Inc A 10.8% 2.7% 5%

American Funds NWld A (EM) 27.2% 23.3% 71%

1 -- dividends, gains reinvested through June 30

Source: Lipper

Document USAT000020090706e5760003d

MONEY
How $100 would have fared

298 words
6 July 2009
USA Today
USAT
FINAL
B.4
English

How much a $100 monthly investment would have fared in the largest stock mutual funds, ranked by assets.

Value of $100 invested a month

Fund

5 yrs.

10 yrs.

Amer Funds Gro Fund of Amer. A $4,909 $12,124

Vanguard Total Stock Mkt Index $4,866 $10,821

Vanguard 500 Index $4,803 $10,377

American Fds EuroPac.Gro A $5,450 $15,030

Ame Funds Capital Inc. Builder A $5,222 $14,554

Amer Fds Cap.Wrld Gro. & Inc. A $5,226 $15,371

SPDR Trust Series 1 $4,807 $10,388

Amer Funds Income of Amer. A $4,990 $13,235

Vanguard Institutional Index $4,817 $10,439

Amer Funds Invest. Co. of Amer. A $4,787 $11,692

Fidelity Contrafund $5,360 $13,195

Amer Funds Wash. Mutual A $4,497 $11,017

American Funds Balanced A $5,116 $13,046

Franklin Income A $5,401 $14,455

Vanguard Wellington $5,874 $14,410

Amer Funds Fundmtl Inv. Inc A $4,945 $12,774

American Funds New Persp. A $5,247 $13,828

Dodge & Cox Stock $4,466 $11,603

Fidelity Diversified Intl. $5,089 $13,762

Vanguard Windsor II $4,770 $11,543

iShares MSCI EAFE Index $5,105 NA

Davis New York Venture A $4,571 $11,216

iShares MSCI Emrg. Mkts Index $6,804 NA

Fidelity Growth Company $5,395 $11,967

Dodge & Cox Intl. Stock $5,301 NA

BlackRock Global Alloc. Investor A $6,089 $17,439

Vanguard Primecap $5,441 $12,925

Fidelity Magellan $4,699 $9,712

Fidelity Low-Priced Stock $5,270 $15,641

Fidelity Spartan US Equity Index $4,807 $10,385

$100 a month $6,000 $12,000

Dividends, gains reinvested through June 30

Source: Lipper

Document USAT000020090706e5760003a

MONEY
5 years' best, worst

187 words
6 July 2009
USA Today
USAT
FINAL
B.5
English

Fund (type, see glossary)

Total return

5 yrs.

2009

Winners

iShares MSCI Brazil (LT) 312% 55.9%

iShares S&P Lat Am 40 (LT) 230% 38.5%

T Rowe Price Int Lat (LT) 228% 47.6%

BlackRock Latin Amer A (LT) 225% 50.4%

Fidelity Latin America (LT) 189% 39.9%

Fidelity Adv Lat Am A (LT) 183% 40.1%

DWS Latin Am Eqty S (LT) 159% 35.0%

Dreyfus Greatr China A (CH) 158% 73.9%

USAA Prec Met{Min}Rtl (AU) 155% 20.5%

Van Eck Intl Gold A (AU) 147% 20.5%

Evergreen Prc Mt A (AU) 138% 15.5%

DFA Emg Mkts Value I (EM) 135% 41.4%

Eaton Vance Grtr Ind A (EM) 134% 52.5%

Matthews Asia China (CH) 133% 39.1%

Fidelity Sel Gold (AU) 131% 13.6%

Losers

Frontier Microcap (SC) -86% 2.8%

ProFunds Banks Inv (FS) -84% -37.8%

ProFunds Mobile Tel Inv (TL) -83% 66.2%

Direxion SC Bl 2.5x Inv -80% -12.9%

ProFunds Financials Inv -77% -18.6%

1 -- dividends, gains reinvested through June 30

Source: Lipper

Document USAT000020090706e57600036

MONEY
10 years' best, worst

179 words
6 July 2009
USA Today
USAT
FINAL
B.5
English

Fund (type, see glossary)

Total return

10 yrs.

Q2

Winners

ING Russia A (EM) 641% 56.3%

USAA Prec Met Rtl (AU) 609% 20.5%

Evergreen Prc Mt A (AU) 569% 15.5%

First Eagle Gold A (AU) 554% 15.0%

Gamco Gold AAA (AU) 486% 22.8%

Tocqueville Gold Fund (AU) 457% 28.6%

BlackRock En & Res A 432% 25.5%

DWS Gold&Pr Metal S (AU) 402% 15.4%

OCM Gold (AU) 388% 17.2%

Van Eck Intl Gold A (AU) 387% 20.5%

BlackRock Latin Amer A (LT) 372% 50.4%

T Rowe Price Int Lat (LT) 372% 47.6%

US Glbl Gold&Prec Mtls (AU) 369% 14.8%

Oppenheimer Gld & Sp A (AU) 363% 28.4%

ICON Energy (NR) 362% 2.1%

Losers

Frontier Microcap (SC) -99% 2.8%

ProFunds UltraNasdaq Inv -93% 40.1%

Embarcadero Sm-Cap Gro (SG) -91% -0.6%

Embarcadero Mkt Neutral (TK) -87% 3.7%

Embarcadero Abs Return (SG) -86% 11.0%

1 -- dividends, gains reinvested through June 30

Source: Lipper

Document USAT000020090706e57600035

MONEY
Mergers mean fewer mutual funds ; Companies get rid of their less successful offerings

John Waggoner
433 words
19 June 2009
USA Today
USAT
FINAL
B.1
English

The mutual fund industry is shrinking, and a wave of mergers and acquisitions could diminish it further.

Fund companies have eliminated 208 funds this year, vs. 281 for all of 2008, according to Lipper.

After two devastating bear markets this decade, "A lot of fund companies are looking for ways to get lean and mean," says Lipper analyst Tom Roseen. Getting rid of small and poorly performing funds is one way to do that.

Although funds typically become profitable when assets pass $50 million, many larger fund companies are interested only in funds with assets of $500 million or more, says Bert Greenwald, a Philadelphia fund consultant. "Unless they can grow a fund's assets to half a billion dollars, they're going to think twice about maintaining them," Greenwald says.

Funds have also been merging unwanted funds into larger, more successful ones this year, although at about the same pace as last year. Companies have eliminated 72 funds that way this year, vs. 172 for all of last year.

Merger-and-acquisition activity means that more redundant funds will be eliminated. There's no reason to offer two Treasury-only money market funds, for example.

Banks seeking to raise capital might be the biggest sellers of mutual funds in the coming months. The largest recent deal: Barclays' move to sell iShares, its giant exchange-traded-fund arm, to **BlackRock** for $13.5 billion.

The iShares deal could spark other financial companies to shed their fund businesses: The final sale price was at least double the initial bids. "The **BlackRock** deal sent a signal that people are buoyant and optimistic for the fund industry," Greenwald says. "And banks are clearly motivated sellers."

Other rumored deals: Bank of America may be looking for a buyer for the Columbia funds, and Lincoln Financial Group may sell the Delaware funds, says Geoff Bobroff, a fund consultant. "We've seen a smattering of banks indicate that the fund business didn't fit with their long-term view," he says.

Jefferies Putnam Lovell, an investment banking firm, says that although there will be fewer mergers and acquisitions this year, they will be larger than last year.

"As they seek ways to raise capital, distressed banks and insurers are finding their fund businesses are among the most saleable assets," Aaron Dorr, managing director at Jefferies Putnam Lovell, said in a recent study of M&A activity in the fund industry.

GRAPHIC, Color, Veronica Salazar, USA TODAY, Source: Investment
Company Institute (line graph)

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MONEY
Uncertainty keeps health care stocks down

John Waggoner
855 words
29 May 2009
USA Today
USAT
FINAL
B.3
English

You're driving along in your '89 Buick, and you hear a horrible rattling noise. Unfortunately, it's not your transmission: It's your abdomen. The doctors screen every inch of you, find nothing and bill you for $10,000. And you wonder: Is there any way I can make money off this?

Why, of course there is. Health care stocks are cheap and offer a long-term play on the increasingly aged Baby Boom. But, thanks to the uncertainty about U.S. health care policy, you have some time to ponder your moves before buying a health care fund.

The stock market hit bottom on March 9, when the Standard & Poor's 500-stock index swooned to 676.53. Since, it has rallied 34.5%, including dividends, putting it in bull market territory. But S&P's health care sector index has rebounded just 17%.

What ails health care?

David Farhadi, co-manager of the Alger Health Sciences fund, points to health care reform being a top priority for the Obama administration. Look at health care stocks the week of Feb. 23, when the president delivered a speech on health care reform, Farhadi says, and you see that "it delivered a massive hit to most of the players."

The unknown makes Wall Street sick, and at the moment, the details of Obama's plan are unclear. And that's why investors are steering clear of the sector. You can operate in many other sectors that don't have as much uncertainty.

Worries about the U.S. dollar also weighed on many of the big pharmaceutical stocks, says Samuel Isaly, manager of the Eaton Vance Worldwide Health fund. The Federal Reserve's trade-weighted dollar index soared for much of last year, which hurts U.S. companies' earnings from abroad.

This bears some explanation. Suppose your company earns 1 million euros in profit from German sales each quarter. Suppose it takes $1.50 to buy a euro, so your profit is $1.5 million. Now let's say that the dollar rises in value, enabling investors to buy a euro for just $1.30. Your profit gets cut to $1.3 million.

Nevertheless, health care stocks have certain charms. Unlike a CAT scan, health care stocks are cheap. A standard way to look at a sector's relative value is through its price-earnings ratio -- a stock's price divided by its earnings per share. The lower the P-E, the cheaper the stock, relative to earnings.

Standard & Poor's says that the health care sector trades at 11 times 2009 earnings, vs. 16.4 times earnings for the broad market as a whole. Compared with 2009 earnings, then, health care stocks are reasonably cheap.

Scott Callahan, co-manager of Icon Healthcare fund, likes to look at a sector's fair value price, which is the fund's estimate of all of the sector's companies' intrinsic values, given their future earnings prowess. He thinks health care stocks are worth about $1.13 for every dollar invested -- which is to say, they're cheap. Stocks in the managed health care subsector are particularly cheap at $1.37 for every dollar invested. "Of all the sectors, it's at the top in terms of value," Callahan says.

Apparently, some health care companies feel that the stocks are cheap, too: The industry has had several large acquisitions recently, including Merck's recent purchase of Schering-Plough and Roche's purchase of Genentech. Eaton Vance's Isaly thinks there could be as many as 15 more acquisitions of smaller biotech firms in the offing.

Cheap stocks can remain cheap for a long time, however, and it's unlikely that you'll see big moves in health care stocks until the Obama administration rolls out details of its health care plan. Isaly thinks some of those fears may be overblown. "He had an aggressive agenda, delivered in February, that now looks unrealistic," Isaly says.

What's an investor to do? Health care accounts for about 14% of the S&P 500, so if you own a broad-based index fund, you already own a big slug of health care stocks. If you want more, consider investing in a top-performing health care fund. The top performers for the past five years are in the chart. But you might want to wait until some of the industry's uncertainty has been patched up.

John Waggoner's column appears Fridays.

E-mail: jwaggoner@usatoday.com. Follow at www.twitter.com/ johnwaggoner.

TEXT OF INFO BOX BEGINS HERE

Healthy returns

Top-performing health care funds the past five years:

Fund, ticker

Total return

2009

5 yrs.

BlackRock Health Sciences Opportunities Portfolio Investor A, SHSAX 0.7% 35%

Fidelity Select Medical Delivery Portfolio, FSHCX10.7% 25%

JennDry Jennison Health Sciences Fund A, PHLAX-0.1% 24%

Alger Health Sciences Fund A, AHSAX 2.2% 22%

Schwab Health Care Fund Investor, SWHFX -4.2% 14%

Average health care fund -2.6% -3%

1 -- Dividends, gains reinvested through Wednesday

Source: Lipper

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MONEY
Key to recovery may be in Calif. ; Area is home to a cadre of influential bond fund managers

Matt Krantz
1,013 words
9 April 2009
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English

LOS ANGELES -- The credit crunch rolled from the East Coast across America like a tidal wave. But the U.S. is about to be whipsawed by a riptide rolling back from Southern California.

Best known for its celebrities and beaches, the region also is an enclave of the world's largest and most influential bond fund managers. And it will be these bond fund managers and their decisions of how to use their massive pools of cash to buy that will determine in large part when the credit crisis ends and the bond market stabilizes.

These firms are expected to be key players in the government's efforts to auction off many of the mortgage-related assets that have gummed up credit markets, necessary to get money flowing to companies, home buyers and entrepreneurs.

Southern California bond firms "are going to be enormously influential in both the methodology of tomorrow for bonds and in the actual construction of the markets," says Cynthia Steer of investment consulting firm Rogers Casey. "There's no question their influence is giant and deep-seated."

The size and influence of Southern California's bond investors and their importance in helping mend battered U.S. financial markets is evident from the fact it is home to:

*The largest buyers of bonds for institutions. Two of the three largest institutional bond investment managers are in Southern California, namely Pimco in Newport Beach and Western Asset in Pasadena, according to Institutional Investor. Pimco is the U.S. bond operation of Allianz Global, and Western Asset is the bond operation of Legg Mason. The two combined run more than $750 billion for large U.S. institutions, such as pension plans and endowments. The other of the Big 3 is New York's **BlackRock**.

*The largest buyers of bonds for individuals. That includes two of the three largest bond mutual funds: Pimco's Total Return is No. 1 followed by No. 3 Los Angeles-based American Funds' Bond Fund of America, says Morningstar. Vanguard's Total Bond Market Index is No. 2.

*The most skilled firms. All of the past five top fixed-income managers are from firms based in Southern California, going by the widely watched Fixed Income Manager of the Year award from industry tracker Morningstar. Thomas Atteberry and Robert Rodriguez of Los Angeles-based First Pacific Advisors won the award for 2008, following managers at Pimco in 2007, TCW in 2006 and Metropolitan West in 2005.

So while bonds are largely created and sold from New York, much of the buying is by the Southern Californian behemoths.

Why California has turned into such a bond-buying powerhouse is unclear. Some chalk up it up to randomness. Others say many of the junk-bond experts who moved to Beverly Hills along with former junk- bond king Michael Milken in the 1980s created a bank of expertise in the region.

Others are more cynical. TCW's Jeffrey Gundlach, widely recognized for spotting and vocally warning of the credit bubble, says the area's advantage is that it's about the farthest you can get from the sales pitches of the New York firms that make a living selling the debt instruments. "If you buy into the myths and lies of Wall Street, you will be a poor bond investor," he says.

The credit crisis, though, has created discord in this usual slow- and-steady crew. Some top players are criticizing rivals' tactics. And for the first time in years, different strategies applied by managers are leading to large performance gaps. Several bond firms in the area turned in mixed performances last year, a few losing 10% or more. Some better performers smell blood, hoping clients will defect from the larger firms.

TCW's Gundlach says some of the larger bond firms have exposed their clients to outsize risks by playing in the bond derivatives market. Some of these firms placed complicated trades binding them to buy bonds at preset prices in the future. By using these contracts, rather than buying bonds outright with cash, some managers boosted short-term returns by taking on additional risk, he says.

Investors, stunned by their losses last year, will likely move their money from larger firms that bet wrongly on these derivatives, Gundlach says. "How can you not give up on them? They're supposed to be credit experts."

Western Asset's Ken Leech, who was chief investment officer until taking medical leave last year, doesn't deny the year was tough. But Leech, now working as a strategy adviser for Western, says the firm has the experience to navigate through the crisis. And while the firm uses derivatives, he says they're common in the industry, and they can allow clients to benefit from corners of the bond market that normally would be too small to dabble with.

Meanwhile, the region's bond investors are braced for what could be an even more difficult year in 2009. Being too aggressive could lead to another big year of losses. But being too cautious could mean missing out on historically high yields and seemingly once-in- a-lifetime prices. "A lot of pension funds and endowments are in a state of shock," says Rodriguez, who, despite his fame as a conservative bond investor, races Porsches on the weekends. "This year will be much more challenging."

TEXT OF INFO BOX BEGINS HERE

Southern California's mega bond funds

A challenging bond market is causing a dispersion in the performances in many of the region's largest funds

Fund

Symbol

2009 YTD

2008

TCW Total Return TGLMX 2.5% 1.1%

Pimco Total Return PTTRX 1.5% 4.8%

FPA New Income FPNIX 0.8% 4.3%

Metropolitan West Total Return MWTRX 0.3% -1.5%

American Funds Bond Fund of America ABNDX -0.4% -12.3%

Western Asset Core Plus WACPX -0.6% -9.6%

Source: Morningstar

PHOTO, B/W, Matt May for USA TODAY

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MONEY
Diversification eases losses but can't stop them ; Still, spreading investments out is a solid move

John Waggoner
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You diversified your portfolio, spreading your risk between U.S. and international stocks, high-quality bonds and low-quality bonds. Your portfolio still got stomped.

Is it time to re-think diversification strategies?

No. But it's a good time to make sure you're really diversifying your portfolio -- and that you're not making your diversification play into a core holding.

When you diversify, you spread risk among several different types of investments. And diversification is a good strategy.

Don't believe it? Ask someone whose entire retirement plan was in Bear Stearns stock. Or in Lehman Bros. stock.

"Puh-leeze," says Richard Thaler, professor of economics at the University of Chicago. "Any mutual fund is more diversified than the company you work for."

And while stock mutual funds fell a staggering 37.5% last year, many individual companies fared far worse, says Howard Silverblatt, senior analyst at Standard & Poor's. He counts 256 stocks in the S&P 500 that performed worse than the index -- and that's just among companies that have survived. AIG, for example, tumbled 97.3%, and General Motors plunged 87%. Only a handful of S&P 500 stocks actually turned in a gain last year.

Worth the trip?

Clearly, holding a diversified stock fund is better than gambling on an individual stock. But what about other diversification plays?

Consider international funds, which have tumbled even more than U.S. funds. For example, the average international large-company core fund fell 44.5% last year, vs. 37.2% for the average U.S. large- company core fund. ("Core" funds are those that look for the stocks of growing companies selling at a reasonable price -- a common stock- picking strategy.)

Going overseas brought you nothing but sorrow last year. Should you give it up as a strategy?

No, but perhaps you should tone it down, says Robert Doll, chief investment officer of **BlackRock**. "Correlations have moved up a lot."

Foreign stocks tend to move in lockstep with U.S. stocks these days -- particularly when the markets are down. If the Dow Jones industrial average falls 500 points in a day, you can bet that Japan's Nikkei average is going to have a bad day, too.

But a good day in U.S. markets doesn't necessarily translate into big gains abroad.

International funds also pose an additional risk because of currency conversion. A fund that invests in French stocks has to value its holdings in dollars each day.

A rising dollar hurts a U.S. fund's overseas holdings, while a falling dollar helps it.

For example, suppose your fund had a stock that was valued at 100 euros per share. At the time, one euro was worth $1.40, so the stock sold for $140 per share. The next day, the stock was still selling for 100 euros per share, but the euro fell in value to $1.38. The fund's stock is now worth $138 per share.

Because the dollar rose last year, many international funds got a double whammy: falling stock prices and a rising dollar. For example, the German stock market fell 44.5% last year in euros. Figured in dollars, German stocks plunged 47.2%.

Emerging markets, another favorite diversification play, fared even worse. The BRIC countries -- Brazil, Russia, India and China -- were supposedly the hot growth countries.

But they plunged when the U.S. market tripped:

*Brazil, down 58%

*Russia, down 74%

*India, down 65%

*China, down 52%

If you still think international diversification is worthwhile, make sure you limit it to a set portion of your portfolio and rebalance when that allocation gets too high or too low. Most experts figure that about 20% of your stock portfolio -- not your entire portfolio -- should be in international funds.

Diverse at home

Being diversified doesn't mean holding two similar stock funds. In general, you should aim to own funds that have different investment styles -- say, a bargain-hunting large-company fund and a red-hot small-cap growth fund.

Alas, U.S. diversification didn't help much last year, either. Large-company value funds fell 37.4%, while small-company growth funds plummeted 42.1%. Virtually all types of diversified U.S. stock funds fell an average 35%.

But some U.S. specialty funds have been touted as good diversifiers. Real estate funds, for example, tend not to be closely correlated to the broad stock market.

Unfortunately, real estate was at the heart of the credit crisis. Most real estate funds invest in real estate investment trusts, which, in turn, invest in commercial property -- apartments, shopping malls and office buildings, for example. As the residential real estate market collapsed last year, Wall Street began to worry that commercial real estate wasn't in much better shape. As a result, the average real estate fund tumbled 39.9%.

You might reconsider real estate funds as diversifiers. Besides, says Doll, "If you own a home, you have enough real estate."

Another favorite 2008 diversification play: commodities. Several academic studies have suggested that the prices of metals and agricultural goods move in the opposite direction from stocks. Ideally, adding a small position in commodities will help cushion stock downturns.

Some commodities did that -- just not as much as investors would have liked. Gold funds, for example, fell 28% last year. Diversified commodities funds fell 41%.

What to do

Don't expect that a diversified portfolio will keep you from all losses. Diversification eases losses, but it doesn't cure them. Realize, too, that last year's meltdown was the equivalent of a 100- year flood, a financial crisis the likes of which hasn't been seen for decades. "It's an extraordinary time," says Thaler. "We haven't seen a time when real estate prices have fallen at the same time all around the country and around the world."

Even many types of bonds -- usually the most resilient defense against stock drops -- got clobbered in 2008. A few junk-bond funds, which invest in low-quality, high-yielding corporate IOUs, fell more than 70% last year, as Wall Street worried about rising defaults.

Only Treasury securities were immune from the carnage. But now many experts figure that the Treasury market will be the scene of Wall Street's next sell-off. Should any type of investment seem more promising in the short term, the minuscule returns from T-bills will seem utterly unappealing.

Where will they go? Who knows? And that's one reason to spread your investment net wide. Use one or two broadly diversified stock funds as your core position, and add bonds to reduce your risk. If you think that commodities, gold, real estate or international stocks will help, add some of those, too. But add them sparingly -- and if they soar, trim them back from time to time.

TEXT OF INFO BOX BEGINS HERE

These funds were the best performers in their categories last year. No, really.

China region

ING Greater China, v44.3%

Basic materials

Fidelity Select Chemicals, v43.3%

International real estate

ING Europe Real Estate, v43.1%

Global science

and technology

WisdomTree International Tech, v39.3%

International small/midcap growth

Third Avenue International Value, v37.2%

Latin America

iShares MSCI Chile, v37.0%

Emerging markets

SPDR S&P Emerging Middle East & Africa, v36.7%

International large-cap core

Jamestown International Equity, v35.0%

S&P 500 index funds

California Investment Trust S&P 500, v35.6%

International small/midcap value

Tocqueville Int'l Value, v34.9%

International large-cap value

Morgan Stanley Inst: v33.1%

Telecommunications

iShares S&P Global Telecomm, v32.9%

International large-cap growth

Dreyfus International Stock, v31.6%

Natural Resources

First Trust ISE Water, v29.8%

Pacific region

Matthews Asia Pacific, v26.0%

GRAPHIC, B/W, Sam Ward, USA TODAY (illustration)
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MONEY

Sludgy energy stocks could be refined in 2009 ; Oil prices could bounce back, and then so will natural resources shares

John Waggoner
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Today's price of oil represents the wise and sober assessment of all available information by all market participants.

Ahahaahaha! Just kidding. In reality, the price of oil reflects the fear that the world economy, as we know it, will fall into a kind of fiscal coma, followed by alternating periods of decrepitude and collapse.

Should the world economy move up from recession to normality, however, it's a good bet that the price of oil will rise late next year -- and that means, in turn, that energy stocks and natural resources funds will be the chief beneficiaries.

Natural resources funds have been pumping mud this year, falling an average 47.5%. Although the bear market is partly to blame, the collapse in oil prices is the main culprit, because resources funds invest primarily in energy stocks.

The price of a barrel of light, sweet Texas crude soared to $145.29 on July 3, up 51% from the start of 2008. Oil had soared more than 1,111% since 1998, when a barrel of oil cost about $12 -- less than a case of beer.

But the oil gusher went dry. Oil for January delivery closed Thursday at $47.98 -- up 10% for the day, but still 67% off its July highs. What happened?

Global financial collapse. Demand has plunged since July because of the economic slowdown. "Most driving is work-related," says Tom Kloza, chief oil analyst for the Oil Price Information Service. You don't drive as much when you're laid off.

Because the recession is global, people in India and China aren't driving as much, either. World economic growth could fall 2% or 3% in the coming year -- which doesn't sound like much but is enormous. "It's like a 2- to 3-degree temperature drop for a human being," Kloza says.

Some experts are getting bullish on oil, however, not because demand is rising, but because it's not falling as fast as it was earlier in the year. "We might be seeing the worst on demand as we speak," says Timothy Parker, energy analyst at T. Rowe Price.

Predictably, energy stocks have been clobbered -- too much so, says Derek Rollingson, manager of ICON Energy fund. "They're a tremendous value," he says. He figures investors get about $1.80 in value for each dollar invested in energy now.

Dan Rice, manager of **BlackRock** Global Resources, thinks that current energy stock prices assume that oil will stay in the $40-to- $50 range forever. "If the global economy slows 3% to 4% for the foreseeable future, that might be correct," he says. Should the world economy eventually recover to 2% to 3% growth, however, oil could hit $90. And already, the Organization of Petroleum Exporting Countries has started to cut production, which should prop up oil prices.

If you're worried that the economy won't recover, the safest bet is via the big diversified oil companies, such as ExxonMobil (ticker: XOM). But ICON's Rollingson thinks Occidental Petroleum (OXY) is far more undervalued.

BlackRock's Rice thinks that the smaller energy companies -- many of which have fallen 80% or more in the energy rout -- are worth a look. If the world economy revives, even to 1% annual economic growth, a basket of small, beaten-up energy stocks will fare far better than ExxonMobil. Of course, if the economy stagnates, these stocks will get clobbered, too.

For most investors, a basket of stocks is better than one or two individual holdings, and that means investing in a mutual fund. The funds with the best long-term records are in the chart.

You might also consider exchange traded funds, which you can buy and sell on exchanges, just like stocks. Most energy ETFs simply track an index, which means they operate at lower costs -- and are immune to wrong guesses by portfolio managers. Two to consider:

*iShares S&P GSCI Commodity fund (GSG). This fund has a big slug of energy stocks but also invests in other commodities, such as agriculture, metals and livestock, which makes it a bit more diversified.

*Energy SPDR (XLE). The biggest energy ETF, this fund tracks Standard & Poor's energy index.

You shouldn't bet more than 5% of your portfolio on energy: After all, if you own a diversified fund, you've probably got energy stocks there, too. But at these low levels, adding a bit of energy could help fuel your portfolio in 2009.

Some top performers for past 5 years

Top-performing natural resources funds the past five years: Total return{+1}

Fund, ticker 2008 5 yrs.

ICON Energy Fund, ICENX -32.3% 116%

Columbia Energy & Natural Resources,, UMESX -42.9% 79%

Fidelity Select Energy Portfolio, FSENX -53.6% 64%

Rydex Energy Fund Investor, RYEIX -45.0% 61%

Morgan Stanley Natural Resource, NREBX -45.4% 60%

Average natural resources fund -47.5% 60%

1 -- dividends, gains reinvested through WednesdaySource: Lipper

John Waggoner's column appears Fridays. His new book, Bailout: What the Rescue of Bear Stearns and the Credit Crisis Mean for Your Investments, is available through John Wiley & Sons.

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PHOTO, B/W

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MONEY

Look for some stock gems amid the rubble ; Tough times mean there are bargains to be had

John Waggoner
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Given the stock market's wretched performance this year, your current retirement plan may involve a modest part-time job, such as woodworking or forgery.

Before you take up a life of crime, however, remember that really rotten markets sometimes uncover opportunities. In fact, the worse the market, the more bargains you can find. And right now, you can buy stocks and bonds of the nation's best-run and most profitable businesses at astoundingly low prices. What's more, you can collect dividends and interest while you wait for the economy to recover and for other investors to regain their senses.

First, and let's not whitewash things here, the current market has all the appeal of a weekend in the local viper pit. The Dow Jones industrial average plunged 679 points on Thursday alone; it has shed 5,585 points, or 39%, in the past 12 months.

And not all of the selling is hysterical. The banking system is a mess and the economy is sinking. People who bought stocks under the assumption that profits would rise have good reason to rethink their position. Nevertheless, when investors dump stocks in panic, sometimes good stocks get thrown out with the bad. In fact, when the stock market is in panic mode, good stocks often get thrown out first. Consider the plight of some hedge funds, which are freewheeling investment pools for the extremely wealthy.

Many hedge funds borrowed to buy stocks, a technique that increases gains in a rising market, but amplifies your pain when stocks fall. These funds now have to raise cash to repay their margin loans and to pay off departing investors.

"The reason for the sharp decline is massive selling from hedge funds -- not because they want to, but because they have to reduce their leverage," says Kenneth Heebner, manager of CGM Mutual. "It's the biggest margin call since 1929."

In a big, panicky decline, big investors can't sell their worst investments, because no one wants them. Instead, they sell their best holdings, because they can be converted into cash quickly. And sometimes that means that you can buy very good stocks at good prices.

Let's start our search by eliminating the entire financial sector. Sure, there are probably good bargains there. But right now, it's hard to tell which banks, brokers or insurers will emerge unscathed.

One simple screen is the Dogs of the Dow. These stocks are the 10 stocks in the Dow that have the highest dividend yields. Why is a high dividend yield doggish? The dividend yield is a company's 12- month payout divided by its price. Many times, companies with high dividends aren't being generous. They have gotten their share prices slashed.

For example, a company that pays $1 a year per share in dividends has a 2% dividend when its share price is $50. If its price falls to $25, its dividend yield leaps to 4%. In theory, when you buy one of the 10 highest-yielding Dow stocks, you're buying stock of a big, financially strong company that is temporarily in distress. For example, General Electric has paid $1.24 per share in dividends the past 12 months. At its current share price, GE's dividend yield is 6.5%.

Now, it may well be that GE has harder times ahead. On the other hand, it's unlikely the company will cut its dividend. So you can collect 6.5% in dividends while you wait for the company to turn around. Other non-financial companies in the Dogs of the Dow: Pfizer (ticker: PFE), Verizon (VZ), AT&T (T), Merck (MRK), DuPont (DD), Home Depot (HD) and Alcoa (AA). You can get more information on the Dogs of the Dow at www.dogsofthedow.com.

For those who don't want to pick individual stocks, an equity- income fund typically looks for stocks of strong, dividend-paying companies. The best equity-income funds are in the box.

Investors have been dumping high-quality corporate bonds, too -- and that means similarly high yields for retirees and pre-retirees who are comfortable with some risk. Currently, high-quality bonds are "as cheap as I've seen them in 50 years," says Loomis Sayles star bond-fund manager Dan Fuss. Cheap, to a bond-fund manager, means that a bond's yield is high, relative to comparable Treasury securities.

Buying individual bonds can be trickier than buying stocks, so you're probably better off investing in a high-quality bond fund. Managers Bond, a no-load fund also run by Fuss, is one good choice.

You probably won't buy stocks or bonds at the absolute bottom of the market. But investing in high-quality stocks and bonds now makes sense -- and it's less likely to put you in the slammer than taking up forgery.

John Waggoner's new book, Bailout: What the Rescue of Bear Stearns and the Credit Crisis Mean for Your Investments, is available from John Wiley & Sons. His column appears Fridays.

Top performers among equity-income funds

Top-performing equity-income funds the past five years: Total return{+1}

Fund, ticker 2008 5 yrs.

Amana Income Fund, AMANX -21.0% 86%

1st Source Monogram Income Equity Fund, FMIEX -26.7% 65%

BlackRock Equity Dividend Fund B, MBDVX -28.8% 53%

RiverSource Diversified Equity Income Fund A, INDZX -36.1% 50%

Waddell & Reed Dividend Opportunities Fund A, WDVAX -30.0% 46%

Ivy Dividend Opportunities Fund A, IVDAX -29.5% 45%

1 -- dividends, gains reinvested through Wednesday

Source: Lipper

PHOTO, B/W; GRAPHIC, B/W

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MONEY

BofA buys out Merrill in bold move ; CEO: It's the 'strategic opportunity of a lifetime'

Kathy Chu; Matt Krantz
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Bank of America's purchase of Merrill Lynch will create the nation's largest retail bank even as it signals the end of independence for the 94-year-old brokerage house known for bringing Wall Street to Main Street.

Bank of America's decision to acquire Merrill Lynch in an all- stock transaction -- the culmination of 48 hours of frenzied negotiations -- will give it the nation's largest retail brokerage network and a sizable investment banking presence.

It's a bold move and a noteworthy reversal for CEO Ken Lewis, who last fall, when steep trading losses in BofA's own investment banking division helped cut the bank's third-quarter profits by almost a third, said he wasn't interested in growing it.

"I've had all the fun I can stand in investment banking at the moment," he told banking analysts in a conference call, according to a transcript.

Lewis was more upbeat Monday about BofA's prospects with the nation's biggest brokerage house in its growing empire. Buying Merrill was the "strategic opportunity of a lifetime," Lewis said.

Investors were less enthusiastic. In a day that saw steep losses in the market, BofA's shares fell 21% to $26.55. Merrill's shares rose a penny to $17.06.

With the bank's shares worth less, that cuts the value of the transaction to less than $40 billion, or about $22 a share, from about $50 billion, or $29 a share, based on Friday's closing prices.

The acquisition is an aggressive move by Bank of America to expand its already gigantic financial footprint only two months after acquiring Countrywide, previously the nation's largest independent mortgage lender. It comes as a growing number of financial institutions are teetering amid a faltering economy and soured real estate investments.

Bank of America is already the largest credit card issuer and mortgage lender. But the merger -- expected to close in the first quarter of 2009 -- will boost its investment-management business because of Merrill's 50% ownership in **BlackRock**, a global asset manager with $1.4 trillion under management.

Ladenburg Thalmann analyst Richard Bove, in a research note Monday, called Bank of America's acquisition "a natural fit" because it increases the brokerage sales force by 16,000 and makes the combined company a major stock underwriter. Other analysts were cautious. Moody's Investors Service put some of Bank of America's debt ratings on review for a downgrade, saying the acquisition poses "substantial integration challenges" at a time when the economy remains weak and Bank of America is digesting its purchase of Countrywide, a mortgage lender pummeled by loan defaults.

Market jitters

Quincy Krosby, chief investment strategist at The Hartford, an insurance company, said the sell-off in Bank of America's stock Monday is a sign of "jittery financial markets" and investor concerns about "overall system risk in the credit system."

"What the market is saying is BOA overpaid," Krosby says. "But Bank of America didn't want to risk losing the deal. It wanted to lock in the deal."

But Bank of America has proved skeptics wrong before. When it acquired FleetBoston Financial in 2003 for $45 a share, analysts thought it overpaid. But the deal has generally been seen as a boon to BofA, expanding its presence in the Northeast and then making it the second-largest U.S bank, by assets, behind Citigroup.

Bank of America's latest deal took shape this weekend, as executives from major Wall Street firms huddled with top Fed officials inside the stone fortress-like building of the New York Federal Reserve Bank in Lower Manhattan.

Merrill Lynch Chief Executive John Thain jump-started the whirlwind merger talks when he phoned Bank of America Chief Executive Lewis on Saturday morning to explore the possibility of a merger, the executives told reporters Monday.

Bank of America's adviser, J.C. Flowers, a private-equity firm, had done "quite a bit of due diligence" on Merrill Lynch in recent years, says Lewis, which was "one of the key ingredients in being able to do this as quickly as we did."

Merrill has lost more than $45 billion on its mortgage investments, raising fears that it could be the next bank to go under. The firm was one of the largest issuers of collateralized debt obligations, which are securities that package together mortgage and other debt and are sold to investors.

Merrill however, has taken aggressive steps to reduce its exposure to risky assets, putting it in better shape than some of its competitors. In July, it said it would take a pretax write-down in the third quarter of $5.7 billion, to sell off a chunk of its riskiest investments at a sharp discount.

Lewis says Bank of America, which just Friday had been weighing a purchase of Lehman Bros., turned its attentions to Merrill because it was the "opportunity of a lifetime."

Lehman, unable to find a buyer, filed for bankruptcy court protection Monday morning.

Thain says the merger wasn't the "outcome I would have expected when I took this job," but that it's a win for Merrill shareholders because they'll own stock in the "leading most-diversified financial services company."

The deal's quick turnaround, says Thomas Cooley, dean of NYU's Stern School of Business, also reflects the "volatility in the economy and the fear that others could follow the fate of Lehman."

Deal experience

Lewis is no stranger to large acquisitions. Before the Countrywide purchase -- which is still being integrated -- Bank of America in 2005 purchased MBNA, mainly known as a large credit card issuer. During Lewis' tenure as CEO, the bank has also bought Chicago-based LaSalle Bank, FleetBoston and U.S. Trust.

Lewis' banking career started in 1969 as a credit analyst at NCNB Corp., a company that eventually merged into the behemoth known as Bank of America. He took the reins of Bank of America in 2001, and has cultivated a reputation for aggressive dealmaking.

Buying Merrill Lynch raises the question of whether the deal would violate banking regulations that say no bank can hold more than 10% of the nation's deposits, says analyst Bove.

Lewis, on a CNBC interview Monday, dismissed this concern, saying that a portion of Merrill's deposits is from thrifts and industrial loan corporations, which are not subject to banking rules.

Would bank be dangerously indispensable?

Still, the bank's growth raises concerns because it is now "one of the few indispensable titans of the world," says Peter Schiff, president of brokerage firm Euro Pacific Capital and author of Crash Proof: How to Profit from the Coming Economic Collapse.

By buying Merrill, Bank of America has made itself "too big to fail," at a time when other weakened financial institutions are seeking government assistance, Schiff says.

The deal won't solve all of Bank of America's troubles. Lewis said Monday that he doesn't expect the economy to begin recovering until the second half of next year.

"I don't see the clouds parting, as I would like them to, in 2009," Lewis says.

But Anthony Polini, an analyst at Raymond James, says the merger was the best option for Merrill. Had the deal not been arranged this weekend, shares of Merrill likely would have plunged and severely reduced the price any buyer would be willing to pay, Polini says.

Also, Polini says, the weak economy has allowed Bank of America to capitalize on a rare opportunity to pick up assets at prices some wouldn't have expected years ago.

As the economic turmoil continues, more troubled institutions will be under pressure to strike deals with larger and better- capitalized firms.

"It is definitely a very, very difficult time and it's not going to get better quickly, but it will eventually, and we will be well positioned when it does," Thain said Monday.

Adds Lewis: "There are going to be fewer companies, and we're going to have to be better at what we do."

TEXT OF INFO BOXES BEGINS HERE

Biggest U.S. banks and thrifts

Top banks and thrifts in the USA, ranked as of Sept. 15 by total assets (in billions):

Company Assets Deposits

Bank of America 1 $2,882.1 $923.8

Citigroup $2,100.4 $803.6

JPMorgan Chase $1,775.7 $722.9

Wachovia $812.4 $447.8

Wells Fargo $609.1 $339.1

1 reflects Bank of America's acquisition of Countrywide Financial and its pending acquisition of Merrill Lynch

Source: SNL Financial

Mortgage originations

Bank of America took control of Countrywide this year. Their combined volume of mortgage originations in the first half of 2008 was $75.5 billion more than No. 2 Wells Fargo.

Mortgage originations

Lender (billions)

Countrywide $132.0

Wells Fargo $129.0

Chase $115.2

Bank of America $72.5

Citigroup $65.7

Residential Capital $35.7

Source: MortgageDaily.com

Credit and debit card spending

Estimated card spending, debit and credit, in 2008 (in billions):

Bank of America $507.71

JPMorgan Chase $381.6

Citi $250.2

Wells Fargo $144.2

U.S. Bank $109.2

1 with Merrill Lynch Source: TowerGroup

PHOTO, Color

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MONEY
Lehman tries to head off trouble ; Analysts wonder if bank can pull off turnaround

Matt Krantz; Kathy Chu
449 words
11 September 2008
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English

Lehman Bros. unveiled on Wednesday a broad plan to raise cash after suffering sizable investment losses, yet another sign that the credit and housing crunch dogs the financial system.

The nation's No.4 investment bank says it will reduce its residential mortgage holdings, spin off commercial real estate to shareholders, sell 55% of its investment management unit and cut its dividend by 93% in an effort to boost its financial health.

The firm says it expects to post a $3.9 billion net loss for its third quarter, which ended in August, following a $2.8 billion loss in the second quarter.

The deep losses show the severity of the credit crunch, says Michelle Clayman, managing partner of New Amsterdam Partners. "The biggest thing is the tightness of credit," she says. "That will affect the markets and economy for a while."

Investors were unimpressed. Lehman shares sank 54 cents to $7.25. They are off 89% this year.

Lehman's plan left some analysts wondering whether the firm can:

*Quickly reduce its exposure to real estate. Lehman cut residential mortgage holdings by 31% in the third quarter and is in talks with **BlackRock** Financial to sell $4 billion in British residential mortgages. Reducing housing investments is wise, as the market may not recover until the second half of 2009, says Graham Tanaka, portfolio manager at Tanaka Growth, which owns Lehman shares.

Meanwhile, Lehman plans to spin off up to $30 billion in commercial real estate in a separate company called REI Global in early 2009. By spinning off the unit, Lehman gets the exposure off its books without settling for fire-sale prices, Tanaka says.

*Raise additional capital. The plan to sell 55% of its investment management business is a fast way to raise as much as $3 billion.

Lehman did not say who might want the business, which includes Neuberger Berman. But private-equity firm Blackstone is among the bidders, says Sanford C. Bernstein's Brad Hintz, based on talks with retired Neuberger Berman executives.

*Remain independent. Lehman may survive the credit crunch without selling to a rival with deeper pockets, says John Foff, analyst at research firm SNL Financial. "Yes, they could stay independent," he says.

But Lehman says it's open to all options, which could include an outright sale. Lehman might be attractive to foreign firms such as BNP Paribas, Deutsche Bank and Barclays, Hintz says. Lehman, though, needs the credit and housing markets to recover, says Bill Fitzpatrick, analyst at Optique Capital Management. "Until we see stability, Lehman is still in trouble," he says.

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MONEY
Love a bargain? How about a sale within a sale?

John Waggoner
1,023 words
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English

If you're a value investor, you like bargains. What if you could buy a value fund at a discount? That would be like a clearance sale at Costco or 50 cents off from the dollar store. But you can now buy several value funds at a discount price, and a few of them are genuine bargains.

Value investing is a school of stock analysis based on a few fairly simple propositions. The first is that stock prices can rise and fall dramatically over time. The second is that sometimes they do so for fairly stupid reasons, giving investors a chance to buy the stocks of good companies cheaply.

For example, Apple, creator of the iPod, the iPhone and the Apple computer, cost $194.84 on Jan. 2, before swooning to $119.15 by Feb. 26, a 39% decline. The stock now sells for about $179, or 9% less than its starting point this year.

Was Apple really worth 39% less in February than it was in January? Not likely. One could argue, with the benefit of hindsight, that Apple was a screaming bargain at that price.

The dark side to value investing is that some companies whose stocks have fallen sharply are just stinkers, or wildly overvalued in the first place.

Many value funds have been clobbered this year because mutual fund managers snapped up cheap stocks that were merely awful. Legg Mason Value Prime, for example, once outperformed the Standard & Poor's 500-stock index every year for 15 years running, thanks to manager Bill Miller's eye for spotting bargains. This year, though, the fund has plunged 27.6% -- 15.7 percentage points more than the Standard & Poor's 500-stock index has.

One problem: Miller, like many other value investors, owned a big slug of financial stocks -- about 22% of the portfolio, according to Morningstar, the mutual fund trackers. Value investors tend to gravitate to financials because such stocks often carry low prices, relative to earnings, as well as decent dividend yields. But bank stocks have the unfortunate habit of melting down every decade or so, catching value investors flat-footed.

The fact that value funds are lagging these days should hardly consign value investing to the scrap heap of history. Investment styles, after all, move in and out of fashion. It's hard to argue with the proposition that buying stocks cheap is a good idea. And, interestingly, investors now have a chance to buy some fairly good value funds at an additional discount. Here's how.

A few fine value fund managers run closed-end funds, which are a peculiar breed of mutual fund. Like all funds, closed-end funds invest in a portfolio of securities. Most garden-variety funds continually issue and redeem shares as investors move in and out of the fund. But closed-end funds issue a set number of shares, just as a company does when it goes public. The fund then uses the proceeds from the sale of those shares to buy and sell securities. The closed- end fund's shares trade on the stock exchange, just as a company's stock does.

What makes closed-end funds so peculiar? Most times, a closed- end fund's share price doesn't accurately reflect the value of the securities in its portfolio. Consider Dreman/Claymore Dividend & Income fund (ticker: DCS). On Wednesday, the fund's securities were worth $11.78 a share. But the fund sold for $10.09 a share, or a 14.35% discount, in closed-end parlance. Put another way, in the unlikely event that DCS were to liquidate and distribute the proceeds, shareholders would enjoy an instant gain.

The fund's manager, David Dreman, is a noted value manager and, like Miller, Dreman has gotten his clock cleaned lately. DCS has fallen 31.3% this year, according to Morningstar. It's not hard to see why. Among the fund's top 25 holdings are Fannie Mae, down a stunning 79% this year, and Washington Mutual, off 68%.

Buying shares of the fund now, even with its hefty discount and startling 10.2% dividend yield, is an act of courage. It's hard to overlook a 31.3% plunge. On the other hand, a few less mercurial closed-end value funds are also on sale these days. Gabelli Dividend & Income Trust (see chart), for example, is run by star manager Mario Gabelli and has surpassed the S&P 500 by about 1.1 percentage points a year for the past three years.

BlackRock Dividend Achievers Trust invests in companies with a history of raising dividends, which is a good long-term investment strategy. **BlackRock** Strategic Dividend Achievers fund has fared somewhat worse over the past three years than its sister fund. One should probably assume that whatever strategy the fund is using isn't working and stick with the plain-vanilla **BlackRock** Dividend Achievers fund.

The difference between finding a big bargain at a thrift store and one in the stock market is that the thrift store gives you instant gratification: You can lug home that cut-rate moose head right away. Stock bargains take a bit more patience -- but they can be far more rewarding than a moose head.

John Waggoner's column appears Fridays. E-mail: jwaggoner@usatoday.com

TEXT OF INFO BOX BEGINS HERE

Closed-end value funds for the frugal

These closed-end value funds sell for less than the value of the securities in their portfolios. But are they bargains? The cheapest closed-end value funds:

Fund, ticker Discount Total return{+1}

BlackRock Strategic Dividend Achievers Trust, BDT -15.3% -7%

Dreman/Claymore Dividend & Income Fund, DCS -14.4% -34%

Gabelli Dividend & Income Trust, GDV -13.8% 13%

Eaton Vance Tax Advantaged Dividend Income Fund, EVT -13.4% 18%

BlackRock Dividend Achievers Trust, BDV -13.1% -6%

Average large-company value fund -- 8%

1 -- Dividends and capital gains reinvested through Wednesday.

Sources: Morningstar, Lipper, Standard & Poor'sCapital IQ.

PHOTO, B/W

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MONEY

A truly good value can take some work to spot ; Price is only the starting point for a smart investor's search for a winner

John Waggoner
888 words
22 February 2008
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USAT
FINAL
B.3
English

Way back in the late Jurassic period, when you could buy a comic book for less than $5, you could also buy X-ray Specs for just $1. X- ray Specs would have been a great value, except they didn't really let you see through solid objects like Superman.

As a generation of deeply disappointed boys discovered, "value" isn't the same thing as "cheap." They fell into the value trap. For something to be a great value, it has to be something you can buy for less than you'd normally expect to pay.

Given the stock market's dreadful performance this year, you might expect that you can now find great bargains. You'd be right. And some of the best bargains may be among the funds that do the searching for you.

Value investing means buying stocks cheaply, in the hope that eventually they'll rise to their intrinsic value. It's a time- tested strategy: Large-company value funds have gained an average 9.9% a year over the past 15 years. Large-company growth funds, which seek out companies with bright earnings prospects, have gained an average 8.4% over the same period, according to Morningstar, the investment trackers.

But value investing isn't the stock market's equivalent of the Northwest Passage -- a quick shortcut to riches. Value endures bad years, too, and last year was one of them. Large-company growth funds soared an average 13.4% last year, compared with a 1.5% gain for large-company value funds.

Financial services stocks were the biggest value traps last year. Value funds are often attracted to financial stocks, because they often have low price-to-earnings ratios. (The price-to-earnings ratio is a stock's price divided by its past 12 months' earnings. Lower is cheaper.)

The typical large-company value fund has 23.8% of its assets invested in financial services stocks, vs. 9.8% for the average growth fund.

Bank stocks looked cheap in the summer, but they still weren't a bargain. Citigroup, for example, closed at $47.90 on the last day of July, down from $55 in mid-May. Back then, Citi sold for 12 times earnings.

A bargain? At $25, Citi certainly looks appealing now. But its P- E is 37 -- nosebleed territory, particularly for a bank. That's because even though Citi's price dropped, its earnings fell much more, thanks to its subprime losses.

Some would argue that, using current earnings estimates of $3.12 a share for 2008, the company is a bargain at just eight times earnings. Should those estimates pan out, then Citi is indeed a bargain. But accurate earnings forecasts for gargantuan banks are elusive; major international banks are complex creatures.

"We spend more time talking about financial (stocks) than anything else," says Eileen Rominger, manager of Goldman Sachs Large- Cap Value fund. "Every line on their balance sheets represents a degree of estimate."

Though you can start your search for value with beaten-up stocks, or stocks with low P-Es, that's just the starting point. You also need to consider:

*Debt. A company with a high level of debt can't survive a downturn as well as one with low debt.

*Earnings. No one wants to buy a stock that doesn't have earnings or the potential to grow earnings, notes James Cullen, manager of Pioneer Cullen Value. "You want to buy growth at a value price."

*Management. "They all have good game plans and vision," Rominger says. "The best clue you have to how good management is, is by looking at how they have spent shareholders' money over time."

In other words, has the company been reinvesting its earnings into its most productive business lines?

If you feel that picking bargains yourself is too difficult, consider investing in a fund that aims for value. The five large- company value funds with the best five-year records are in the chart.

You might also consider a closed-end value fund. These funds trade on the stock exchanges, just like stocks. Unlike most mutual funds, however, a closed-end fund's price rarely reflects the actual value of its holdings. Instead, it signals investors' opinion of the fund's prospects. And when investors are pessimistic, you can often find some real deals.

Consider Gabelli Dividend & Income Trust (ticker: GDV). Its holdings are worth $21.41 a share. But its share price is $18.39 -- or about a 14.1% discount. Were the fund to liquidate and distribute the proceeds to shareholders, they'd get a $3.02 profit per share.

Because the fund is a value fund, it's presumably buying bargain stocks -- which you, in turn, are receiving at a discount. Other similar funds are Dreman/Claymore Dividend & Income (DCS), **BlackRock** Strategic Dividend Achievers (BDT) and MFS Special Value Trust (MFV).

True bargains may indeed require a form of X-ray vision. But these funds, at least, are one easy place to start your quest for value.

John Waggoner's column appears Fridays. E-mail: jwaggoner@usatoday.com.

PHOTO, B/W; GRAPHIC, Color

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MONEY
Investors fear some earnings will skid ; Unease seeps into markets, stock prices

Adam Shell
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B.1
English

NEW YORK -- If profits are the gas that powers stock prices, it's clear Wall Street is betting that corporate earnings are about to stall out. And that translates into a red light for jittery stock investors.

Indeed, a big reason why stocks are off to a bad start this year is because many investors suspect that U.S. businesses won't make as much money this year as analysts think. If so, stocks will likely fall to reflect the new economic reality. Despite rallying Wednesday, the Standard & Poor's 500 is off 4% in 2008.

Analysts predict that nine of 10 S&P 500 sectors will post double- digit profit gains in '08, Thomson Financial says. They expect full- year '08 growth of 16.1%. The optimism comes even though profit growth turned negative in the third quarter for the first time since 2002 and is projected to be negative again in the final three months of 2007.

Some investors are questioning whether even the mid-single-digit profit growth expected in the first two quarters of '08 is doable. That means the fourth-quarter earnings season, which got its unofficial start Wednesday when Alcoa reported its results, is even more important. If companies don't give reasonably rosy '08 outlooks, watch out, says Gary Kaltbaum, money manager at Kaltbaum & Associates. "If they start lowering their numbers, the market isn't going to be happy."

Kaltbaum says that the market is vulnerable if stocks outside the battered financial and consumer discretionary sectors issue downbeat forecasts, as telephone giant AT&T did Tuesday when it warned of a soft consumer business.

The big risk to corporate profitability is the threat of recession, the odds of which are rising because of the fallout from the housing bust, mortgage meltdown and credit crunch. Compounding the angst: Recessions tend to take a big bite out of corporate profits. S&P 500 profit growth has, on average, dropped 20% in recessions, LPL Financial says. Such a drop would erode a key market support: cheap valuations. A 20% profit slide would boost the market's price-to-earnings ratio to 17 from 13.6.

In recessions dating back to the early 1950s, the S&P 500 has plunged 25.6%, on average, from the market peak prior to the recession, says Citi Investment Research. Much of the damage to stocks occurs in the months leading up to the recession as investors start to price in lower earnings, the Citi report shows.

Stocks can avoid a more serious decline if the earnings carnage is contained, notes Bob Doll, strategist at **BlackRock**. "There is room for earnings disappointments without killing the market. But earnings can't fall 20%. If they do, it means we are in a recession."

GRAPHIC, Color, Source: Thomson Financial (CHART)

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MONEY
Funds by the numbers

364 words
7 January 2008
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B.4
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$160,150

The amount a $10,000 investment in **BlackRock** Global Resources 15 years ago would be worth now. The energy fund is the top performer for the past 15 years. Price of a barrel of crude 15 years ago: $16.77.

$139

The amount a $10,000 investment in Frontier Microcap 15 years ago would be worth now. The fund is the worst performer for the past 15 years.

$837 billion

Assets of the seven largest stock funds from the American Funds, counting all share classes.

$756 billion

Gross domestic product of Australia. The combined assets of the seven largest American funds would rank 15th in world GDP, just behind Mexico.

$503 billion

Market capitalization of ExxonMobil, the largest U.S. corporation. The cash position of the Growth Fund of America -- $23.6 billion -- could buy NYSE Euronext, which owns the New York Stock Exchange.

359

Number of exchange traded funds in 2006. ETFs first arrived on the scene in 1993, with the SPDR Trust, which tracks the broad- based S&P 500.

613

Number of exchange traded funds in 2007. New ETFs include such minuscule slices of the market as the Market Vectors Nuclear Energy ETF and the HealthShares Autoimmune Inflammation ETF.

5

Number of exchange traded real estate ETFs in 2006. Aw, who cares about real estate?

27

Number of exchange traded real estate ETFs in 2007. We do! We do!

$3.1 trillion

Assets in money market mutual funds at year's end, according to iMoneyNet. Money fund assets soared $764 billion, or 32.9%, last year.

3.99%

Average money market yield at year's end. At that rate, your money doubles every 18 years.

5.5%

2007 gain for the Standard & Poor's 500-stock index, with dividends reinvested.

6.3%

2007 gain for the average U.S. stock fund.

5.9%

Average annual gain for the S&P 500 the past 10 years.

6.7%

Average annual gain for the average U.S. stock fund the past 10 years.

PHOTO, B/W, Stephen Hilger, Bloomberg News; PHOTO, B/W, Christian Charisius, Reuters; PHOTO, B/W, Spencer Platt, Getty Images

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COVER STORY
MONEY
Merrill cuts its losses, and its CEO ; Company gets started rebuilding its reputation

Greg Farrell; Adam Shell
1,766 words
31 October 2007
USA Today
USAT
English

NEW YORK -- The Stanley O'Neal era is officially over at Merrill Lynch. But the $2 trillion question -- namely, whether Merrill Lynch can regain its footing as the firm trusted by mom-and-pop investors on Main Street as well as investment bankers on Wall Street -- is very much up in the air.

As expected, O'Neal resigned Tuesday, less than a week after admitting that he had underestimated the firm's losses in the subprime mortgage market.

But what might have come as a surprise is that rather than name a successor, Merrill's board of directors elected Alberto Cribiore as interim non-executive chairman and asked him to form a search committee to identify the firm's next CEO. Meanwhile, two of O'Neal's key lieutenants -- Ahmass Fakahany and Gregory Fleming -- will continue to run the company on a day-to-day basis as co- presidents.

So Merrill is searching for a new leader while its future as the nation's premier stock-brokerage firm is at stake. It is arguably at its most important crossroads in a generation, as losses from the imploding subprime mortgage market blew a hole in its earnings, eroded faith in a firm that until recently was a shining success and sent its stock price to a two-year low.

A good part of the shine came off Merrill's reputation last week when it announced the largest quarterly loss in its history. The primary cause was a write-down of $7.9 billion in the area of collateralized debt obligations (CDOs) and subprime mortgages. To make matters worse, just weeks earlier, Merrill had announced the write-down would be $4.5 billion. The sudden increase in the write- off suggested that Merrill, which still has $20 billion in exposure to the subprime mortgage sector, didn't have a handle on the depth of its financial problems.

When it comes to write-downs and special charges, investors prefer to see companies digest their problems at once and move on. That's why Merrill's double-clutch this month spooked investors -- and why there is so much concern about who will lead the firm out of this crisis.

"That's as high a number I've seen," says Eric Fitzwater, analyst at SNL Financial. "It's still a distinct possibility that Merrill may have to take additional write-downs."

The fluctuating write-down was a sign that the problems at Merrill went beyond the factors that have been hurting the investment banking industry, says Mark Lane, analyst at William Blair. "In most people's eyes, this is a management issue, a risk- management issue, and a large enough number, looking at past history, to prompt a lot of management change," he says.

O'Neal's fall

O'Neal's resignation, following several days of wrangling with the board of directors, ends an almost five-year reign that until a few months ago was noteworthy for its success.

Starting in 2002, O'Neal took a bloated, overextended firm and slashed costs mercilessly, firing more than 20,000 people and shutting down offices around the world. He de-emphasized Merrill's traditional role as stockbroker to the average Main Street investor and refocused its business on high-net-worth clients, investment banking and global capital markets.

As a result, Merrill morphed into a much more efficient and profitable firm. Its stock price hit an all-time high of $98.68 early this year.

But O'Neal's single-minded pursuit of profits came at a price. His predecessors, including David Komansky and Dan Tully, liked to talk about the strong corporate culture at Merrill, which emphasized collegiality along with performance.

Under O'Neal's watch, people skills didn't matter anymore. Within months of his ascension to the top job, he fired an array of senior executives, some of whom had been his rivals and some of whom had been his biggest supporters. The message: Making it at the new Merrill would be all about performance and whether you followed O'Neal in lockstep.

Ultimately, it would be O'Neal himself who would be judged on performance. In 2006, after watching other Wall Street banks turbocharge their earnings with investments in CDOs based on subprime mortgages, O'Neal invested heavily in the area.

When the subprime market caved in this summer, Merrill held a disproportionate share of assets tied to that sector, putting the firm at risk of a big third-quarter loss. How he handled that risk, and Merrill's inability to manage it properly, ultimately did O'Neal in, say those who have followed his career.

"He blew it," says Richard Bove of Punk Ziegel. "He was aggressive and didn't understand the signs of when to pull back."

"He was so enthusiastic about the returns in subprime that he missed the high risks," says Jeff Sonnenfeld of the Yale School of Management.

Over the past few years -- which were an ideal environment for investment banks due to low interest rates, global growth and liquidity -- all the major Wall Street firms were able to "mint money," says Matthew Albrecht, stock analyst at Standard & Poor's.

But when the credit markets were strained, the firms that didn't manage their risks got burned, Albrecht says. "It appears that Merrill Lynch was one of the big firms with the worst risk- management policies," he says. The massive size of the loss begged for change at the top, Albrecht says.

O'Neal paid for his mistakes with his job, but financially, he'll walk away flush. Merrill said O'Neal would not get any severance, or a bonus for 2007, and that his salary stopped Tuesday. But because of his long service to the company, O'Neal will be able to keep all of his stock-option grants and restricted stock accumulated over the years, a sum that approaches $160 million.

Nell Minow, editor at The Corporate Library, which rates companies on the basis of corporate governance, says Merrill's board has a habit of rewarding failure. "Their CEOs are going to get paid very, very well, whether they perform or not," she says.

Yale's Sonnenfeld says the board should not have been surprised by the developments of recent weeks, but the lack of financial experts among directors could have added to O'Neal's problems.

At the same time, Sonnenfeld notes that one board member, Armando Codina, has had a ringside seat at several corporate governance disasters: He was on Winn-Dixie's board when it sought bankruptcy protection two years ago, and served on Home Depot's board last year when it allowed Bob Nardelli to walk away with several hundred million dollars following a poor performance as CEO. "Armando has seen an awful lot of disasters," he says. "He probably has a low threshold for surprises."

The swift action by Merrill's board to boot O'Neal is a clear sign of tougher corporate governance and shareholders' pressure on companies, says Shirley Westcott, managing director at the Proxy Governance consulting firm.

"Boards will not hesitate to dismiss a CEO if they feel that they and shareholders have lost confidence in his abilities," Westcott says. " Home Depot, Hewlett-Packard and other companies have dismissed CEOs under very public circumstances."

To buy or to sell?

Some Wall Street investors are looking at Merrill's recent woes as more of a buying opportunity than a reason to sell. The stock closed Tuesday at $65.56, down 34% from its 52-week high.

Arguing that Merrill's franchise -- which boasts an army of roughly 16,000 financial advisers -- is still intact, the stock is currently undervalued by roughly 12% to 15%, says Ryan Lentell, analyst at Morningstar. Lentell values

Merrill at $76 per share. "Except for fixed income (the division that holds the subprime paper), the company is in pretty good shape," he says.

Merrill's other major business lines have fared well in 2007. Equity markets revenue, says Lentell, is up 23%, investment banking revenue is up 38% and global private bank revenue is up 16%. And Merrill's nearly 50% stake in money management firm **BlackRock** has also been profitable.

But not everyone buys that rosy outlook. "It's a question of risk," says Bill Fitzpatrick, analyst at Johnson Asset Management, who rates the stock a "sell."

Two big risks remain. Merrill is expected to write down further losses on bad bets tied to mortgages gone bad in the fourth quarter. Also, the firm's investment banking division, a big revenue producer, may fall victim to a talent drain as competitors seek to capitalize on Merrill's woes by luring away their top producers.

"The bonuses at Merrill are going to be smaller, and coveted investment bankers might jump ship," Fitzpatrick says.

The temporary pop in the stock over the past week -- driven by speculation that O'Neal would be ousted -- is not sustainable, Fitzpatrick says. "It's just short-term traders pouncing on a distressed stock to make some quick money," he says. "You don't have long-term buyers in there yet." The stock could languish until the full losses are known, he says.

Bove says O'Neal should not have been pushed out, since it puts Merrill back where it was five years ago, re-creating its business without the benefit of time-tested veterans. Bove's biggest criticism of O'Neal is he fired so many experienced people that there was no one to warn him about overexposure to credit risk in the subprime market. Bove placed a "sell" on the stock this week, saying he did not have "faith that this board understands the need to build a long-term business plan or the capability to execute it."

Win Smith, the son of one of the firm's founders, says the fundamentals at Merrill remain strong. Like Bove, he says the key problem under O'Neal's reign was the loss of top managers who'd been through hard times before. "When you get rid of institutional memory, it's very difficult to deal with a crisis," he says. "You can't tinker with successful cultures."

Contributing: Edward Iwata in San Francisco and Matt Krantz in Los Angeles

GRAPHIC, Color, Source: Standard & Poor's Capital IQ (BAR GRAPH); GRAPHIC, B/W, Karl Gelles, USA TODAY, Source: Investor.com (LINE GRAPH); PHOTO, B/W, Bloomberg News; PHOTO, Color, Mike Mergen, Bloomberg News

Document USAT000020071031e3av0000c

MONEY
Experts get personal about their own retirement savings

447 words
6 July 2007
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USAT
English

If you're thinking about rearranging your portfolio at midyear, you're not alone. The pros do the same thing. Here's how three investment experts are positioning their own retirement savings for the months ahead.

Russel Kinnel

Director of mutual fund research, Morningstar

Kinnel is doing what he tells other investors to do with their portfolios on a quarterly basis: very little. Kinnel has set a basic asset allocation for his long-term retirement savings, and he fiddles with it only when it's out of balance.

In the past 12 months, he's trimmed his holdings in small- company value funds, high-yield bond funds and real estate, because they had scored big gains. He's also changed his midcap growth fund, because Morningstar has changed the midcap growth offering in its 401(k) plan. The old fund, Turner Midcap Growth (ticker: TMGFX), was booted in favor of Primecap Odyssey Aggressive Growth (POAGX). The Primecap team runs three successful funds at Vanguard; this fund is still small and has plenty of room to maneuver among different stocks and sectors.

Barbara Krumsiek

President & CEO, Calvert funds

Krumsiek started her 401(k) years ago with a mix of 60% stocks and 40% bonds. "I'm very boring," she says. Krumsiek has become more aggressive, though, as she's become more comfortable about holding stocks and now has 75% in stocks and 25% in bonds.

Her biggest change: This year, she's upped the proportion of new money going into her 401(k) plan's international offerings. Because she's invested more in overseas funds -- and because they've performed well this year -- about 25% of the stock portion of her 401(k) account is now in that sector.

Nearly half her stock-fund holdings are in large-company funds, and she's stopped adding to that portion. It's reached her target allocation.

Robert Doll

Global chief investment officer, **BlackRock**

Doll is about as bullish as they come: He's 100% in stocks and stock mutual funds. No big change there.

But he says he's been focusing more on funds that invest in large U.S. multinational companies, such as those in the Standard & Poor's 500-stock index. These companies derive about half their income from outside the USA, making them a suitable international play.

"I'm paying more attention to where earnings come from, rather than where the company is located," Doll says.

If the U.S. economy's robust growth continues next year, large- company stock funds will benefit. His favorite fund sectors: technology, health care and energy.

PHOTOs, B/W (3)

Document USAT000020070706e3760005o

MONEY
Water, water won't be everywhere, so invest in it now

John Waggoner
810 words
8 June 2007
USA Today
USAT
English

Your friend Waldo is fond of showing you all things he squirreled away in 1957. His Frank Robinson rookie card. That big carnival glass punch bowl he bought for $5. His first 100 shares of IBM. You hate Waldo.

But you wouldn't mind buying one or two things that you could squirrel away now and produce in triumph in 2057. (We're assuming that you're remarkably healthy or that you feel kindly towards your heirs.) What would you choose?

We asked several people, all of whom seem pretty good at making money in 2007, what they would buy and hold for 50 years. Their answers were instructive, to say the least.

Ralph Wanger ran the Acorn fund from 1970 to 2003, earning a name as one of the best small-company stock funds in the country. Wanger had three suggestions:

*High-quality Chinese art. As China grows and prospers, the Chinese will have more money for luxuries, such as art. Chinese art is already booming: A painting by Liu Xiaodong, a contemporary Chinese artist, sold for $2.7 million in November.

*Midwest farmland. A booming population is enough to make farmland valuable in 50 years. But corn, used for producing ethanol, may become increasingly valuable as oil supplies dwindle in the next half-century. Jim Rogers, investment guru and former hedge-fund manager, likes agricultural land in Latin America, where water is reasonably plentiful.

*Urban real estate. But only if it's near a large water supply. Wanger suggests Chicago.

Water was a major theme for many of the people we talked to. Tom Marsico, founder of the Marsico funds, suggests investing in water in the western USA, where water is already getting scarce.

Water has been a good investment in the past, says Joe O'Brien, president of WaterColorado.com. An acre-foot of water from the Colorado Big Thompson project cost about a dollar in the 1950s, O'Brien says. It's worth about $10,000 today. (An acre-foot is one acre of water, 12 inches deep, or 325,851 gallons.) "Water runs uphill to money," he says.

You can't just speculate in water rights: It's illegal in Colorado, says O'Brien. You could, however, buy real estate with water on the property, if you really wanted to cash in on Western water.

Robert Doll, chief investment officer for **BlackRock**, a New York investment manager, also thinks water is a good long-term investment. "It's a precious and rare resource," he says.

You don't have to buy a 5 million-gallon canteen to invest in water. Three exchange-traded funds specialize in stocks of water- related companies: PowerShares Water Resources (ticker: PHO); Claymore S&P Global Water Index fund (CGW); and First Trust ISE Water Index fund (FIW).

Another natural resource is also likely to be in demand 50 years from now: gold. Ned Davis, head of Ned Davis Research, would put his money on gold for 2057. "One of the safest bets for the foreseeable future is that the dollar will go down, which suggests that gold will go up," he says.

Typically, the dollar and gold move in different directions. When people lose faith in paper money, they buy gold. Gold is nearly always worth something, even when paper currency isn't.

The dollar could fall for a long time. The government continues to borrow heavily to pay its fiscal debt. Corporations and individuals are heavy debtors, too. "We have a massive debt bubble," Davis says.

Should the debt bubble burst, a wave of defaults would prompt the Federal Reserve to pump money into the economy to keep it afloat. "The Fed would drop dollars from helicopters to stop deflation," he says.

A massive surge of newly printed money, in turn, would drive down the value of the dollar, and drive up the price of gold, Davis says.

Is there an equivalent today of carnival glass, or Frank Robinson rookie cards? Probably. But Ellen Schroy, editor of Warman's Antiques & Collectibles 2008, suggests you put away U.S. bullion gold coins in your safety deposit box. Current gold coins are quite attractive -- and because they're made of gold, might not lose as much value as, say, a Paris Hilton CD.

Your best long-term investment is probably a low-cost stock index fund: The past 50 years, stocks have returned an average 10.73%, according to Ibbotson Associates. But if you really want to impress Ralph -- or his 2057 equivalent -- you might think about Chinese art, water or gold.

John Waggoner's column appears Fridays. E-mail: jwaggoner@usatoday.com.

GRAPHIC, B/W, Source: Money Fund Report, 800-343-5413
(CHART); PHOTO, B/W, Mark Hirsch, Bloomberg News

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COVER STORY
MONEY
10 REASONS WHY THE S&P COULD HIT A RECORD HIGH IN 2007

Adam Shell
1,856 words
2 January 2007
USA Today
USAT
English

NEW YORK

The Dow broke record after record in 2006. But Wall Street downplayed the blue-chip breakout.

The success of just 30 stocks, Dow doubters declared, wasn't enough to signal a complete recovery from the 2000-02 bear market.

Skeptics insisted it was too early to celebrate. The time to get excited, they reasoned, would be when the broad U.S. stock market, as measured by the Standard & Poor's 500, erased its 49.1% bear market loss and set an all-time record of its own.

Will 2007 be the year?

Can the S&P 500 complete its round trip -- from the tippy-top of 1527.46 it climbed to on March 24, 2000, to the depths of despair it sank to on Oct. 9, 2002, when it bottomed out at 776.76?

Never say never. The broad market barometer is 8% away from a fresh peak.

"The bull market in stocks is alive and well, and a breakout above the S&P 500's old high is a real possibility this year," says Rod Smyth, chief investment strategist at Wachovia Securities, echoing the sentiments of many other Wall Street money managers, analysts and investment strategists.

In fact, out of a panel of 10 top Wall Street strategists interviewed by USA TODAY, five predicted the S&P 500 would top its high this year.

A new high for the broader market, if it occurs, is likely to deliver a jolt of confidence to investors. For many people -- especially those who invested heavily in S&P 500 index funds back in the go-go '90s in search of 20% annual returns -- it means they would be back to even, after being underwater for nearly seven years.

It's not too far of a stretch to build a bullish case for another record-setting year on Wall Street.

Where 2006 saw new records for the Dow Jones industrial average, global merger-and-acquisition activity and Wall Street bonuses, 2007 could be the year the S&P 500 makes big headlines by rising to levels never seen before.

1

Stocks are priced for success. At the market peak in early 2000, the stocks in the S&P 500 were selling at super-expensive prices and very vulnerable. Back then, the price-earnings ratio, which measures stock prices relative to corporate earnings, was close to 28, almost double the historical average, according to Standard & Poor's.

Today, stocks, while not dirt cheap, are much more reasonably priced. Based on operating profit estimates for 2007, the market is currently trading at less than 15 times earnings, its lowest since it sported a P-E of 14.5 at the end of 1994, S&P says.

Since 1999, when the S&P 500 first topped 1400, the index's operating earnings per share have increased more than 70%, and the cash on the balance sheets of the 500 companies has more than doubled to $609.6 billion, Abby Joseph Cohen, strategist at Goldman Sachs, noted in her 2007 investment outlook. That so-called P-E contraction translates into more upside opportunities for stocks.

2

P-Es poised to expand. The prices investors have paid for stocks relative to earnings have declined for three consecutive years. But such streaks are unusual. "P-Es rarely contract four years in a row," research by Henry McVey, chief U.S. investment strategist at Morgan Stanley, shows. Since 1905, there have been eight periods in which P-Es contracted three consecutive years, but in only two cases has it occurred four years in a row. "History," McVey writes, "is on our side."

If P-Es expand, that usually means higher prices for stocks, says Jeffrey Kleintop, chief investment strategist at PNC Financial Services Group. By his calculations, "Each point of P-E expansion is equivalent to a 6.6% price gain" for the S&P 500. When you combine that added return with potential gains attributed to earnings growth and dividends, double-digit returns -- and a new record -- are achievable, according to Kleintop's calculations.

"Valuation will be the primary driver of returns in 2007," Kleintop predicts. "We believe the P-E will expand in 2007 for the first time during this business cycle."

3

Free cash to spur deals. Record-setting global M&A deals and leveraged buyouts in 2006 provided fresh demand for stocks. That trend is expected to give stocks a boost again in 2007, says Sam Stovall, chief investment strategist at S&P.

According to Stovall, the drivers of M&A activity will continue to be: a belief that stocks are undervalued, the emergence of private equity as "a potent market force," and an abundance of cash on corporate balance sheets and in the coffers of private-equity funds.

"We see the near-record level of cash (equal to 6.5% of the S&P 500's market cap) continuing to drive buyback activity," says Stovall.

The demand from private equity, which accounted for more than 25% of all U.S. deals last year, should continue as big institutional investors continue to give these private investors more money to invest. Citigroup estimates that these leveraged-buyout shops have as much as $1.5 trillion in buying power. Says Kim Goodwin, head of equities at Credit Suisse: "Private equity is here to stay."

Robert Smith, manager of T. Rowe Price Growth Stock fund agrees: "There is a lot of cash out there, and it will continue to be invested."

4

Supply of stock is shrinking. Last year, companies said they planned to spend at least $437 billion to buy back their own shares, says S&P. Add to that the more than $1.4 trillion in M&A and buyout deals done this year, and what you end up with is fewer shares of stock for sale in the marketplace.

"The wave of deals has dramatically shrunk the supply of stocks," says Liz Ann Sonders, chief investment strategist at Charles Schwab.

Net new stock supply through the end of November, the most recent data available, plummeted $281 billion in 2006, adding to a $118 billion decline a year earlier, says Sonders.

"If heavy cash buyouts continue, the flow of new public offerings, or IPOs, remains temperate, and demand from foreigners and hedge funds stays strong, this rally should have legs," Sonders predicts.

5

Funds may flow back to U.S. stocks. The Dow's 16% gain in 2006 came despite the fact that U.S. mutual fund investors put 85% less money into domestic stock funds than they did a year earlier, according to Sonders. In contrast, net flows to international funds rose from $77.7 billion in 2005 to $112.5 billion in 2006, a 45% increase.

Those statistics are in sharp contrast to the late-'90s, when U.S. investors were pouring record amounts of dollars into technology mutual funds. From a contrarian standpoint, that's bullish for the market, as individual investors "tend to be trend chasers," says Sonders.

In a recent research note, Ed Keon, chief investment strategist for Prudential Equity Group, asked: "Will the American public finally buy some stocks in 2007?" His answer: "I don't know." But he added, "The bull case is likely to get a stronger push, and perhaps new money will drive stocks substantially higher in 2007."

Interest in buying stocks might get a boost from Americans no longer enamored of the real estate market, adds Cohen of Goldman Sachs.

6

Year 3 of presidential cycle bullish. The last time the stock market fell in the third year of a president's term was 1939. While history is no guarantee of future returns, since World War II, the S&P 500 has averaged a total return of 22% in a president's third year in office, says PNC's Kleintop. What's more, stocks have also fared well in the third year of a two-term president's second term, S&P says. "Under Eisenhower, Nixon/Ford, Reagan and Clinton, the S&P 500 advanced an average of 19%," S&P's Stovall says. (President Bush is entering the third year of his second term.)

The main reason for third-year gains has to do with the party in power doing what is necessary to keep the economy humming along in an effort to retain power. In addition, history shows that stocks tend to fare well in periods of "political gridlock," which is likely to be the case in 2007 despite Democrats gaining control of Congress. The reason: President Bush has veto power.

7

Liquidity spigot still open. "Excess liquidity is everywhere," notes Jim Paulsen, chief investment strategist at Wells Capital Management. And it is liquidity -- or cash -- chasing financial assets that pushes prices higher. "Liquidity is increasingly recognized as 'the' defining force in the economy," says Paulsen.

U.S. corporations are liquid, with almost $610 billion in excess cash available to drive stock-buyback programs and mergers, he says. Foreign central banks are also flush with U.S. dollars, including China's $1 trillion-plus reserve of greenbacks. All the cash sloshing around the globe is finding its way into financial assets, including dollar-denominated investments.

8

Skepticism remains high. With the big run-up in stock prices in 2006, you'd think investors would be wildly bullish. Think again. The latest sentiment survey data from the American Association of Individual Investors show that 36% of investors are "bearish" on stocks. That's 8 percentage points higher than the long-term average of 28%.

The fact that there are still stock market skeptics suggests that there is still buying power out there. Stocks would be more vulnerable if everyone were already bullish, because that would mean most investors are already fully invested.

9

Big-cap stocks are due. Small stocks have posted bigger returns than large-company stocks every year since 2000. As a result, large stocks are cheaper relative to their smaller brethren. These larger, stable growth companies are also better suited to keep posting strong earnings in a slowing economy, says Tom McManus, chief investment strategist at Bank of America Securities.

"Some of these large-cap stocks are more attractively valued in absolute terms -- and relative to bonds -- than they have been in many years," McManus says.

Bob Doll, chief investment officer of equities at **BlackRock**, is also bullish on big-cap stocks: "Big will continue to do better," he says. And that would be especially good news for the S&P 500, which is a market-cap-weighted index.

10

Records are meant to be broken.

As the Dow proved last year, stocks always have the potential to reach new highs.

GRAPHIC, Color, Source: CSI (LINE GRAPH); GRAPHIC, B/W, (CHART); PHOTO, B/W, C. East, Reuters/Landov; PHOTO, B/W, S. Hilger, Bloomberg News; PHOTO, B/W; PHOTOS, B/W, USA TODAY (5)

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MONEY
BlackRock to take over Merrill's mutual funds

John Waggoner
650 words
16 February 2006
USA Today
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FINAL
B.3
English

In another sign that the day of the financial supermarket is ending, **BlackRock**, a New York investment management company, will take control of Merrill Lynch's mutual fund arm, the two companies announced Wednesday.

The combination will make **BlackRock** a $1 trillion money- management powerhouse -- and increase Merrill's enormous presence in mutual fund sales.

Investors in Merrill Lynch funds, particularly its bond funds, could see better performance. Merrill's stock-fund performance has improved in recent years, in part because of chief investment officer Robert Doll, formerly of OppenheimerFunds. Doll will become head of stock investments at **BlackRock**

The deal would shift Merrill Lynch Asset Management, which manages Merrill's in-house mutual funds and private accounts, to **BlackRock**. In return, Merrill would get a 49.8% stake in **BlackRock**; that translates into a $9.5 billion price tag on Merrill Lynch Asset Management. Merrill will sell funds that will be managed by **BlackRock** under **BlackRock**'s name.

Like the deal between Citigroup and Legg Mason last year, the Merrill/**BlackRock** swap will separate fund management from the brokerage house that sells the funds. It's a sharp break from a long- term trend of consolidating all aspects of financial services. "Trying to do something for everybody doesn't make sense," says Michael Lipper, head of Lipper Securities.

Sales of a broker's in-house funds have come under regulatory scrutiny, particularly when poorly performing brokerage funds see a surge in sales. In 2003, Massachusetts and New York regulators investigated whether Morgan Stanley paid its brokers more to sell Morgan funds without telling that to investors. Morgan Stanley paid $52 million in fines in November 2003.

Because of these and other well-publicized cases, it's become harder for brokers to sell their own in-house funds. "These companies have to get out from the real and perceived conflicts of selling home-cooked funds," says Burt Greenwald, a Philadelphia- based mutual fund consultant. "This solves a lot of problems for Merrill Lynch."

Other big investment firms are likely to look for similar arrangements. Morgan Stanley tried to buy a controlling interest in **BlackRock** last year, but the deal fell through.

Both Merrill and **BlackRock** say their deal wasn't prompted by regulatory prodding but by each company's strengths and weaknesses. **BlackRock** is noted for its institutional bond funds; Merrill has a huge presence in retail stock and bond funds.

Analysts looked favorably on the deal. Aside from combining the two companies' assets under management, they should be able to cut costs as well. "This has legs," says Gary Townsend of Friedman Billings Ramsey, an investment bank.

PNC Bank, which owns 70% of **BlackRock**, will see its stake shrink to 34%.

Because Merrill's funds will be sold under the **BlackRock** name, the merger solves one other problem for Merrill. The company took heat from Princeton University in January for renaming its funds Princeton Portfolio Research and Management.

TEXT OF INFO BOXES BEGINS HERE About the merger

*Will create one of the world's largest fixed-income managers, with $1 trillion in assets.

*Mutual funds to be sold under **BlackRock** name.

*Laurence Fink will remain **BlackRock** chief executive.

*Robert Doll, of Merrill Lynch Investment Managers, will become vice chairman and chief investment officer of **BlackRock** equities.

*PNC Financial Services' stake in **BlackRock** will decline to 34% from 70%.

*Shares of **BlackRock** rose 3.6% to $151.25 Wednesday; Merrill Lynch closed up 0.6% at $16.43.

Sources: **BlackRock**, CSI

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   Merrill stock funds Fund name   Assets (in billions)   Year-to-
date return Merrill Lynch Global Allocation A   $13.5   3.0% Mercury
Basic Value A   $8.0   3.2% Merrill Lynch Basic Value A   $8.0
3.4% Merrill Lynch Fundamental Growth A   $5.3   0.4% Merrill Lynch
Value Opportunities A   $3.2   5.4% Source: Lipper
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MONEY
Rising commodity prices send natural resources, gold funds soaring

John Waggoner
619 words
9 January 2006
USA Today
USAT
FINAL
B.4
English

Real assets rocked in 2005.

Natural resources funds, which invest in oil, gas and other energy stocks, soared 41%. Gold funds, which buy shares of gold- mining companies, jumped 30.5%. And real estate funds gained 11.8%, vs. 6.6% for the average stock mutual fund.

The funds surged because many commodity prices rose sharply in 2005:

*Crude oil ended 2005 at $61.04 a barrel, a 40% gain from 2004.

*Gold gained $79.60 an ounce in 2005, closing at $517.10, an 18% rise.

*Existing home prices gained 13.2% through November, the National Association of Realtors says.

What's driving red-hot commodities prices? China, whose gross domestic product has quadrupled since 1978. The country's GDP grew at an estimated 8% pace in 2005 and is expected to grow at a 9% rate this year, the National Statistics Bureau of China says.

China's voracious appetite for raw materials, particularly oil, also has pushed up the stock markets of countries that export commodities.

Latin America funds, for example, gained 53% last year, partly because of booming exports. Emerging markets funds, which include Latin American countries, jumped 32%. The huge demand for raw materials also has pushed up the stock markets of big, commodities- producing countries such as Canada, Australia and Russia.

Energy stocks slipped badly in the last three months of 2005, as worries about the effects of Hurricane Katrina on Gulf oil refineries began to recede. The average natural resources fund fell 0.5% in the fourth quarter as oil prices slid.

That may be just a pause, says J.C. Waller, manager of the ICON Energy fund. "We've recouped our losses in the first three trading days of 2006," he says. "Oil stocks paused for a bit, but now they're the leaders in the market again."

Waller is looking for increased volatility in oil prices and energy stocks, particularly because the sector has had such a good run in the past few years. Nevertheless, energy stocks are still undervalued, by his reckoning. Favorite energy subsector: oil and gas drillers. "They're growing at huge rates," he says.

Demand for raw materials, particularly steel, remained strong in the fourth quarter, and funds that specialize in basic commodities fared well. For example, the Select Sector Materials SPDR, an exchange-traded fund that invests in stocks of commodities producers, gained 11.1% the fourth quarter.

Steel and copper prices have been rising steadily, and that has helped big commodities producers. United States Steel has gained 49% the past six months. Freeport McMoRan Copper & Gold has soared 58%.

That trend, too, should continue, Waller says, thanks to demand from China -- and from the USA, where GDP should grow at a 3% pace or better this year. "The U.S. is a big consumer of commodities," he says.

TEXT OF INFO BOX BEGINS HERE Gold Total return Fund 2005 4th qtr. Vanguard Prc Mtl{M}Inv 43.8% 6.8% Franklin Gld Pr Mt Adv 40.9% 16.0% Fidelity Sel Gold 40.7% 17.5% Midas Fund 39.7% 19.1% USAA Metals & Minerals 39.3% 17.6% Avg. gold-oriented fund 30.5% 14.0 1 -- dividends, gains reinvested

through Dec. 31 Source: Lipper

Natural resources Total return Fund 2005 4th qtr. Gartmore Gl Nat Res I 66.0% 2.9% Guinn Atkin Gl Energy 64.0% -4.9%

Blackrock Global Resources 57.2% -1.2% JennDry Nat. Resources A 54.2% 3.2% Fidelity Sel Energy Svs. 54.1% 2.6% Avg. natural resources fund 41.1% -0.5% 1 -- dividends, gains reinvested

through Dec. 31 Source: Lipper

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MONEY
Oil pumps up returns ; But how long can portfolios count on it to fuel windfalls?

John Waggoner
628 words
6 October 2005
USA Today
USAT
FINAL
B.6
English

If your portfolio didn't have any oil this year, it delivered all the performance of a 1961 Rambler. On blocks.

The Standard & Poor's 500-stock index has eked out a 1.4% gain this year, as of the Sept. 30 close (without dividends). But without the 40% average gain from energy stocks, it would have posted a 2% loss, S&P says.

The top-performing funds for the year are dripping with oil: Guinness Atkinson Global Energy. ProFunds Oil and Gas. AIM Energy. All gained at least 50%. The question now: Can oil keep pumping out gains?

More than a few market watchers are skeptical. The Vanguard Group posted a warning on its Internet site last month about the Vanguard Energy Fund and natural resources funds in general. The warning noted that sector funds are volatile and that a decline in oil prices could trigger a decline in energy stocks.

Most consumers would welcome a decline in oil prices, which have soared to $62.79 a barrel from $43.45 at the start of this year. The rise, sparked by enormous demand from China and hurricane damage to rigs in the Gulf of Mexico, might not be sustainable over the long term. "Industry people tell you that the cure for high or low prices is more of the same," says Bill Gerlach, manager of Gartmore Global Natural Resources Fund. "High prices squelch demand and bring on more supply."

Dan Rice, manager of **BlackRock** Global Resources, thinks oil will remain above $50 a barrel the next few years. But energy stocks are priced to reflect earnings at $42 a barrel, he says. "The stocks have a ways to go on the upside," he says.

Most managers agree with him, especially when it concerns the stocks of companies that drill for oil or provide tools and support for drilling. "You'll see increased capital spending," says John Segner, manager of AIM Energy. "Even if oil does go to $50 a barrel, these companies are going to show net earnings growth year over year."

But not all energy is oil. Natural gas, for example, has soared to more than $14 per million cubic feet, nearly double from a year ago.

"We have lost a significant amount of capacity out of the Gulf," Segner says.

But $14 per MCF is unsustainable, says Gerlach. If prices fall, it's reasonable to assume that the prices of natural gas stocks will fall as well, he says.

One winner from high oil and gas prices: coal. New coal supply is minimal, says **BlackRock**'s Rice, and demand should soar as natural gas prices remain high.

AIM's Segner warns that coal stocks are expensive, relative to earnings, and that stocks of the major oil companies, such as ExxonMobil, are cheaper. "They're cheaper than oil drillers and services, and they pay a decent dividend," Segner says.

Overall, the long-term case for energy stocks is compelling: For every 2% increase in global gross domestic product, the world will need another 1 million barrels of oil a day. "Even if growth slows, we're not going to have significant additions to capacity in the next 12 months," Segner says.

But before you invest in energy, make sure you're not already fueled up. The Vanguard 500 Index fund has 9% of its assets in energy stocks, the company says: Many funds have far more. If you fill up with too much oil, your portfolio could seize up if oil prices decline.

GRAPHICS, B/W, Source: Lipper (CHART) (3); PHOTO, B/W, R. Soderlin,
Casper (Wyo.) Star-Tribune, via AP; PHOTO, B/W, Getty Images

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MONEY
SEC hits fat fees on index funds

Christine Dugas and John Waggoner
460 words
4 February 2004
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FINAL
B.02
English

The Securities and Exchange Commission said Tuesday that it is cracking down on exorbitant index fund fees -- the latest segment of the mutual fund industry to face regulatory scrutiny.

Index funds, portfolios of stocks or bonds that track a particular index, typically charge the lowest fees. They don't require stock-picking skills or expensive stock research like most other mutual funds.

Yet the fees charged by index funds vary widely. Fees on S&P 500 index funds, for example, can range from the bargain basement Vanguard Institutional Index fund, with a 0.02% expense ratio, to Scudder's S&P 500 Index fund B, with a 1.41% expense ratio.

The SEC launched the investigation into index fund fees because "you'd expect the fees would not be terribly disparate and yet if you look at the range, it's wide," says SEC enforcement chief Stephen Cutler.

Soft-dollar arrangements are one focus of the review, Cutler says. In a soft-dollar arrangement, a fund pays higher than normal commissions for trading stocks. In return, it gets research from the brokerage.

But index funds don't need research, because all they do is track an index. "We'll be looking at what they are buying with brokerage commissions and if they are buying research, why?" says Lori Richards, director of the SEC's office of compliance inspections and examinations. Richards says the investigation is still at the early stages.

"There is no justification that I can think of for an index fund to use soft dollars to pay for research," says Jeffrey Ptak, mutual fund analyst at investment researcher Morningstar.

Many companies offer index funds, so fees are the main criterion when evaluating them, Ptak says.

For example, the Standard & Poor's 500 stock index has lost 3.7% the past five years. Vanguard Institutional Index, which charges 0.02% in annual expenses, has lost 3.3%. It beat the S&P 500 because of skillful trading by its manager, Gus Sauter.

But **Blackrock** Equity Index B, which charges 1.54% in expenses, lost 10.8% the same period, fund-tracker Lipper says.

Ptak also slammed brokers who sell customers index funds with B shares. B shares have no upfront sales charge but they charge annual marketing fees of up to 1%. Some experts say B shares are rarely a better deal for investors.

With an index fund, they are even harder to justify. "It's an abomination to market such a high-expense fund," says Brent Birodeski, managing director of Savant Capital Management, a Rockford, Ill., advisory firm. "The reason indexing works is low costs."

GRAPHIC, B/W, Source: Lipper (CHART)

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MANAGING YOUR MONEY; Investing
MONEY
Fund sales practices might be costing you

John Waggoner
1,147 words
21 November 2003
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FINAL
B.03
English

Regulators are taking a close look at how mutual funds are sold - - and not liking all they see. Consumers might not be getting important information about mutual funds before they buy. They might not know that their brokerage firm gets payments for funds to be on a recommended list. They might not understand the fees and sales charges they have to pay. Those kinds of sales abuses can cost investors dearly.

Morgan Stanley agreed this week to a $50 million settlement with the Securities and Exchange Commission. The charges: that the company failed to tell consumers important information before they bought mutual fund shares. The settlement is likely to be the start of widespread reform of common industry sales practices.

Unlike the mutual fund trading scandal, which skimmed small amounts from investors, bad sales practices can nick investors for thousands of dollars at a shot. That can mean investors aren't told about the funds that best suit their needs.

Pay to play

Most brokerage houses have "preferred" lists of mutual funds for their brokers to sell. Funds on the preferred lists are the ones brokers recommend first to clients. Brokerages often say funds get on the preferred list because the company has researched the funds and selected only the best.

But many brokerage companies have another reason for putting a fund on the preferred list: Payoffs called "revenue sharing."

Typical charges for getting on a preferred list:

* A fee equal to 0.2% to 0.5% of the value of fund shares that brokerage clients have owned for one year or longer.

* A 0.15% to 0.25% fee, charged on the value of shares sold by the brokerage company.

The payments are usually cash, although some companies might agree to send a fund's stock-trading business to the broker in return for getting on the preferred list.

In theory, these fees are not taken from the funds directly. Instead, they're taken from the profits of the mutual fund management company, which manages the funds' portfolios. But cash fees might be one reason mutual fund fees remain persistently high.

Revenue sharing isn't illegal, any more than it's illegal for a bread company to pay a grocer for eye-level shelf space in the store. And it has been a common industry practice. The real damage: Investors usually aren't told that brokers are pushing a fund because their company is being paid to promote it.

Jack Russell, a former Allstate insurance agent now living in Floyd, Va., gave his retirement account to Morgan Stanley in June 2000. His broker chose funds from Morgan Stanley, AIM, MFS, Putnam and Alliance -- all on Morgan's preferred list. He wasn't told about revenue-sharing payments. "That's collusion; it's criminal," Russell says.

Morgan Stanley admitted no wrongdoing in accepting the settlement. But CEO Philip Purcell has expressed regret that the firm's sales practices had been found inadequate, and pledged to take steps beyond the disclosure requirements.

The $50 million settlement will be given to customers who bought shares on Morgan's preferred list since Jan. 1, 2000. The National Association of Securities Dealers is looking into revenue-sharing arrangements at more than a dozen other major brokerage houses.

Breakpoints

The NASD also says many investors haven't gotten discounts on commissions they were entitled to, called breakpoints. Most funds will reduce upfront commissions for large purchases.

For example, AIM Blue Chip charges a 5.5% commission for investments of less than $25,000. The commission falls steadily from there. A $50,000 purchase, for example, gets a 4.75% commission.

You don't have to make just one purchase to qualify for lower commissions. Different fund companies have different rules on breakpoints. But you might be entitled to a break if:

* You sign a letter of intent pledging to invest a higher amount within 13 months.

* Your total investments with the fund company (or your household's total investments) pass a breakpoint. These might include 529 college savings plans and retirement and brokerage accounts.

* All your purchases at one fund company pass a breakpoint.

Early this month, the NASD directed nearly 450 brokerage companies to notify customers that they might be owed refunds. The NASD estimates investors were overcharged $86 million in 2001 and 2002 alone. Average overcharge: $243.

B shares

Most funds offer several share classes of the same funds. They differ only in fee structure.

Funds with upfront commissions are usually called A shares. B shares have no upfront commission. Instead, the fund company pays the broker a commission, and you repay the fund company through higher ongoing fees. AIM Blue Chip B, for example, charges 2.05% a year in fees, vs. 1.4% for AIM Blue Chip A.

Unlike A shares, B shares have no breakpoints. Brokers get a flat commission, plus a smaller annual commission, called a trail. Unscrupulous brokers have recommended large purchases of B shares, which would pay them larger commissions than A shares with breakpoints would.

Russell says his broker parceled out nearly $400,000 in mutual fund investments in $20,000 lots among B shares of funds from different families, many with very similar investment objectives. For example, Russell bought Alliance Growth B, Massachusetts Investors Growth B, Morgan Stanley American Opportunities B, AIM Blue Chip B and Alliance Premiere Growth B, all large-company growth funds. Had his broker put him in one fund's A shares, he might have saved on fees.

He feels betrayed. "I trusted these people all these years," Russell says.

Morgan Stanley will address any issues with Russell's account, says spokeswoman Andrea Slattery.

If you think you haven't gotten the commission breaks you deserve, the NASD's Internet site (www.nasd.com) has a sample claim form you can fill out and send to your broker.

If you feel you would have been better served with A shares than B shares, contact your broker's supervisor. If that doesn't work, contact the NASD.

TEXT OF INFO BOXES BEGINS HERE

Paying to be a partner

Fund firms that paid to be in Morgan Stanley's Partners program:

* AIM

* Alliance

* American funds

* **BlackRock**

* Davis

* Dreyfus

* Eaton Vance

* Evergreen

* Fidelity

* Franklin Templeton

* MFS

* Morgan Stanley Funds

* Pimco

* Putnam

* Scudder

* Van Kampen

Source: Morgan Stanley

Annual fund expenses

Increasing emphasis on marketing has driven up annual expenses on broker-sold funds, mainly because of 12b-1 marketing fees. Fund expenses by type of sales charge, or load:

Type of sales charge

Average expenses

Front-end load (A shares)

1.32%

Back-end load (B shares)

2.02%

Level load (C shares)

1.97%

No load

1.03%

Institutional load

0.91%

Source: Lipper

Managing your money; Every Friday

GRAPHIC, Color, Sam Ward, USA TODAY (ILLUSTRATION)

Document USAT000020031121dzbl00089

COVER STORY
MONEY
Glasnost puts Grasso under burning-hot spotlight ; NYSE's policy reveals some shocks

Greg Farrell, Thor Valdmanis and Gary Strauss
1,527 words
11 September 2003
USA Today
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NEW YORK -- Just as the Kremlin started opening itself up to the outside world in the 1980s, capitalism's most sacred shrine -- the New York Stock Exchange -- is opening up the vault containing its innermost secrets. At least a crack.

And that crack could jeopardize the future of Richard Grasso as the institution's chairman and CEO.

The NYSE's first major step toward transparency -- the recent disclosures that Grasso will receive a payment of $140 million and that he turned down an additional $48 million that he already had coming -- has sparked a firestorm of protest from investor activists.

Worse yet, the disclosures have shocked some of the NYSE's own board members. Three directors, who insisted that their names not be used, couldn't believe that on Tuesday, just a few weeks after they learned about Grasso's $140 million payday, they found out about the other $48 million in accumulated benefits.

Despite the internal dissent, Grasso and other directors are publicly presenting a united front. On Tuesday, at a press conference to discuss Grasso's compensation, board member Carl McCall -- who heads the NYSE's compensation committee -- said, "Dick was and is the right leader at the right time."

In Washington, D.C., Wednesday, Grasso told reporters that he had no plans to resign over the controversy surrounding his pay package, citing the new contract he recently signed that will keep him at the exchange until 2007.

"I'm excited about the next four years," Grasso said. While he acknowledged the complaints over his pay, he said he had strong support among NYSE membership. "No one is unanimously supported in any walk of life," he said.

Later Wednesday, another member of the NYSE's compensation committee issued a statement regarding Grasso's pay package but sidestepped the issue of whether Grasso should continue as CEO. Through a spokesman, Herbert Allison, CEO of institutional investment firm TIAA-CREF, said that he "fully supports Dick Grasso's decision to forgo the $48 million contractually due to him, and he also supports the board's decision to fully disclose Dick Grasso's compensation."

Glasnost at the NYSE

In an unusual example of its new embrace of transparency, NYSE management allowed reporters to pore over some 1,200 pages of background material on Wednesday, paperwork that showed how the compensation committee determined Grasso's compensation.

But the Big Board's version of glasnost came with a twist: Reporters were allowed only two hours to review the internal documents under the watchful eyes of NYSE personnel, and were forbidden to photograph or reproduce the pages in any way, except by longhand.

During USA TODAY's visit to the exchange, a Wall Street Journal reporter attempted to photograph some of the material with a digital camera. The exchange's Christiaan Brakman, a lanky Dutchman with a thick accent, accosted the reporter and confiscated his camera, warning other journalists in the room not to try to use any "James Bond-type devices."

The NYSE assembled the 1,200 pages of background material in response to a letter from Securities and Exchange Commission Chairman William Donaldson, himself a former CEO of the Big Board.

Donaldson asked the NYSE to review its corporate governance procedures last March. Grasso called Donaldson on his vacation Aug. 26 to tell him that the NYSE board was extending his contract from 2005 to 2007 and paying him $140 million in deferred compensation.

Donaldson was shocked. His salary as NYSE chairman between 1990 and 1995 never topped $1.85 million.

Labor Day weekend, Donaldson decided to write the NYSE board, demanding to know how Grasso's compensation could be so high. McCall sent the NYSE's response, with the 1,200 pages of supporting material, to the SEC on Tuesday.

The 1,200 pages shed some light on Grasso's interactions with the board of directors, and the compensation committee's deliberations over Grasso's contract extension. According to the material:

* Grasso wanted to keep the extra $48 million but gave up his claim to it after several NYSE board members objected.

At Tuesday's press conference, Grasso presented his decision as a magnanimous gesture, designed to keep his focus on running the NYSE.

But minutes of Tuesday's board meeting, which preceded the press conference by a few hours, show Grasso listened to what his board members had to say before making his decision. "A number of the directors expressed their view on the appropriateness of the additional payout," the minutes note.

Then, Grasso and other NYSE managers left the meeting to let the outside directors discuss the matter further. Grasso returned a short time later, before the outside directors had reached a decision, to say he would forgo the $48 million.

* Copies of Grasso's employment contract show that besides what he is paid as chairman, the exchange supplies him with a full-time car and driver, use of a private plane and bodyguards, and paid memberships in various clubs that he uses to entertain guests.

The contract even calls for Grasso to travel with his wife whenever possible, and pledges to pay for "reasonable expenses" they both rack up on the road.

The contract says the NYSE will reimburse Grasso "for all ordinary and necessary expenses in a reasonable amount, which the executive incurs in performing his duties under this agreement including, but not limited to, entertainment, professional dues and subscriptions and all dues, fees and expenses associated with membership in various professional, business and civic associations and societies in which the executive participates."

Grasso puts it behind him

Tuesday, when he said he would give up the additional $48 million, Grasso said he had put the pay issue behind him. But it was the topic du jour Wednesday, on Wall Street and in Washington, where he took part in a panel on corporate governance sponsored by the Business Roundtable trade group. There, Grasso was both defensive and a bit bewildered at the attention his compensation continued to draw.

He patted himself on the back at one point, saying that he had never had a two-way dialogue with the NYSE's compensation committee over his compensation.

But the remark drew criticism from fellow panelist Nell Minow, editor of The Corporate Library newsletter and a longtime critic of excessive pay. "Maybe you should be sitting down with your compensation committee and have a discussion about compensation," she said. "That's what corporate governance is about."

Corporate board consultant Joe Goodwin of The Goodwin Group says Grasso may have to step down to restore shareholder confidence. Given the corporate scandals of the past two years and complaints over executive pay at for-profit companies, disclosures over Grasso's pay package and the lack of transparency by the NYSE could further taint investors' faith in the stock market, Goodwin says.

Compensation analyst Graef Crystal faults the exchange's board of directors and its outside compensation consultants.

Crystal notes that the NYSE's consultants had benchmarked the pay of CEOs at companies including Merrill Lynch and Citigroup to help formulate Grasso's pay. But Crystal says the Wall Street firms had far more income and revenue than the NYSE.

"There should be a significant relationship between the size of the company and CEO pay," Crystal says. "At best, the NYSE is a jumbo shrimp, a tiny enterprise. The consultants ignored the issue of size. And the board ignored the issue that this is a not-for- profit company."

It's not clear where the Big Board's push for transparency will lead, but if the Soviet Union's embrace of glasnost is any example, big changes are coming.

Grasso seemed to sense that in May, in an interview with USA TODAY. "I'm not Viktor Chernomyrdin," Grasso insisted, referring to the former Soviet leader. "I'm not an imperial CEO."

Farrell and Valdmanis reported from New York, Strauss from Washington. Contributing: Adam Shell, Michael McCarthy, David Kiley, Lorrie Grant, James Cox

TEXT OF INFO BOX BEGINS HERE

New York Stock Exchange's board of directors

Those on the human resources and compensation committee are in bold type:

Member

Affiliation

Madeleine Albright The Albright Group (former secretary of State)

Herbert Allison TIAA-CREF

Carol Bartz Autodesk

James Cayne Bear Stearns

James Duryea J.M. Duryea

Robert Fagenson Van der Moolen Specialists

Laurence Fink **BlackRock**

William Harrison J.P. Morgan Chase

Andrea Jung Avon Products

Mel Karmazin Viacom

Kenneth Langone Invemed Associates

Peter Larson Brunswick (retired)

Gerald Levin AOL Time Warner (retired)

H. Carl McCall HealthPoint

George McNamee First Albany

John Mack Credit Suisse First Boston

Stanley O'Neal Merrill Lynch

Henry Paulson Goldman Sachs

Philip Purcell Morgan Stanley

Christopher Quick Fleet Specialist

Jurgen Schrempp DaimlerChrysler

Larry Sonsini Wilson Sonsini Goodrich & Rosati

William Summers McDonald Investments

Source: New York Stock Exchange

GRAPHIC, Color, Julie Snider, USA TODAY, Source: USA TODAY research (BAR GRAPH); PHOTO, Color, Diane Bondareff, AP;
Caption: Money matters: NYSE's Richard Grasso, getting $140 million in deferred compensation, turned down $48 million more.

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MONEY

NYSE expected to push internal reforms ; Financial transparency may come into play

Thor Valdmanis
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NEW YORK -- The New York Stock Exchange is expected to introduce sweeping internal reforms this summer in response to growing criticism of its secretive management style, according to people familiar with the situation.

After months of Wall Street scandal, the issue of greater transparency took on added urgency Wednesday after a published report that NYSE Chairman Richard Grasso received a pay package of more than $10 million last year despite slumping Big Board profit amid a continuing bear market.

News of Grasso's previously unreported salary and retirement package, valued between $80 million and $100 million, came as a shock to shareholder activists pressing for a crackdown on excessive executive pay.

"There is no question that Dick Grasso is in rarefied company," says John Challenger of corporate outplacement firm Challenger Gray & Christmas. "The typical CEO of a Fortune 500 company makes $11 million a year. But Gen. Tommy Franks last year made $154,000 running our military."

The revelation on Grasso's pay, reported in The Wall Street Journal, also comes as the NYSE's integrity is under increased scrutiny. Citigroup CEO Sanford Weill recently withdrew his nomination as an exchange director following criticism that he was a poor choice since regulators had fined Citigroup $400 million for allegedly misleading stock research. The NYSE also is investigating whether several specialist firms engaged in improper trading practices.

The NYSE declined to comment on Grasso's salary, saying it was a private matter between the exchange and its 1,366 members. NYSE board members said it was in line with other top salaries on Wall Street. Merrill Lynch's David Komansky and Stan O'Neal, for example, earn $14 million annually.

But board member Carl McCall, the former New State Comptroller and co-chair of the NYSE's new corporate governance committee, said that there could be a need for better disclosure at the NYSE. "We should provide the kind of information to the public that shows our commitment to transparency," McCall said, adding his committee plans to hold public hearings. He declined further comment. But people close to the situation say the 24-member non-executive NYSE board is likely to push for full disclosure of salaries and benefits given to officers, in addition to other reforms.

Grasso, 56, has spent 36 years at the NYSE and earned praise for his leadership in restoring the nation's capital markets in the days after the Sept. 11 attacks. He has also been instrumental in cobbling together the recent $1.4 billion Wall Street reform settlement. But the Big Board has long been accused of dragging its heels in terms of its own corporate governance.

TEXT OF INFO BOX BEGINS HERE

Compensation committee

* Chairman: Kenneth Langone, Invemed Associates

* James Cayne, Bear Stearns

* Laurence Fink, **BlackRock**

* Mel Karmazin, Viacom

* David Komansky, Merrill Lynch

* Gerald Levin, AOL Time Warner (retired)

* Robert Murphy, LaBranche & Co.

* Henry Paulson, Goldman Sachs

* Jurgen Schrempp, DaimlerChrysler

See related story: 03B

PHOTO, Color, Richard Drew, AP;
Caption: Grasso: Report says NYSE chairman got a pay package of more than $10 million.

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Investing
MONEY
Fund company stocks look hot

John Waggoner
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After the worst bear market in a quarter-century, you might be wondering, "Gosh, how are my mutual fund company executives doing? Are they all right?" Well, relax. They are. And so are most people who invested in the stocks of companies that manage mutual funds. In fact, if you think we're on the verge of a new bull market, you might want to invest in fund-company stocks, too.

The Standard & Poor's 500-stock index has tumbled 17.6% the past two years. But the Lipper Management Company price index, which measures the performance of the 10 largest publicly traded fund companies, has soared 85.7%.

Fund companies are astonishingly profitable, which is one reason they have held up so well. Mutual funds make their money by charging a fee on the assets they manage. Consider Fidelity Magellan, the largest mutual fund in the universe. The fund has $78 billion in assets. Fidelity takes 0.93% of those assets every year to run the fund. Magellan rakes in roughly $725 million in fees before expenses.

Fidelity, a private company, isn't alone. Many of the largest mutual fund companies have very nice net profit margins, indeed -- typically 15% to 20%. For example, T. Rowe Price has a net profit margin of 19.1%. Franklin Resource's profit margin is 18.8%. "Anyone who manufactures would kill for that," says Rachel Barnard, stock analyst at Morningstar. Chipmaker Intel, for example, has a 6.5% profit margin.

More important, it doesn't take 50% more in expenses to manage 50% more assets. When a fund company's assets grow, either through new money or through astute management, profits soar.

Investors have continued to pour money into mutual funds this year, despite the lackluster stock market. Lipper estimates that investors put $30 billion into stock funds in March, the most since April 2000. Toss in variable annuities and closed-end funds, and industry-watcher Avi Nachmany puts the figure at closer to $37 billion. "That's extraordinary," he says.

And many of the publicly traded fund companies could be takeover targets, says Burt Greenwald, a Philadelphia mutual fund consultant. That's not only because they are so profitable. Mutual funds have little global penetration outside the USA and the United Kingdom, Greenwald says. Foreign companies that want to get into the business would love to own a U.S. money manager.

But not all fund companies are screaming bargains, either. Franklin Resources, for example, currently sells for 24 times its past 12 months' earnings. That's less than the S&P 500, but high for money management stocks. Morningstar's Barnard thinks both Franklin and T. Rowe Price are 30% overvalued.

So what looks appealing? Barnard likes:

* Eaton Vance (ticker: EV). It, too, sells for about 24 times earnings. But the company specializes in tax-free municipal bond funds. "Those tend to be really sticky assets," Barnard says. "Once they're there, they stay." Burt Greenwald says the company is a likely takeover candidate.

* **Blackrock** (BLK). Cash is flowing back to bond funds, and **Blackrock** is one of the premier bond managers for pension funds and other institutions.

* Northern Trust (NTRS). The most money in the money-management business is made by catering to the wealthy, and Northern Trust has a long history of doing just that. Their biggest black mark -- a $20 million fourth-quarter write-off for loans to Enron -- is behind them now, Barnard says. "Their trust fees are up, and they look like they're back on track."

* Gabelli Asset Management (GBL). The company, run by star manager Mario Gabelli, has been wading into the hedge-fund business, which can be even more profitable than the mutual fund business.

Any fund-company stock will be more volatile than a mutual fund, and if the stock market goes into a prolonged slump, funds could get hurt, too. On the other hand, if a new bull market is at hand, a fund-company stock will probably be more profitable, too. Think of it this way: About 77 million baby boomers are frantically stuffing money into retirement accounts. Fund companies will collect fees on much of that. Why not get your cut?

John Waggoner's column appears Fridays. E-mail: jwaggoner@usatoday.com

GRAPHIC, B/W, Source: Lipper, Microsoft Investor (CHART)

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