Investment Policy

PaineWebber

The Big Shift —Barely Begun

Flows into equities to continue for at least another 15 years

Highlights

■ As we discussed back in 1991, The Big Shift is on:

- Deposits at banks today account for just 12% of household financial assets, down from a peak of 25% in 1978 and 18% in 1991.
- Equities' share of household financial assets is now 43%, surpassing the prior 1968 peak of 39%, and should go higher.

■ The factors behind the Big Shift into equities should remain in place for the foreseeable future: low interest rates, subdued inflation, education and retirement needs, an inadequate Social Security system.

■ Portfolio shift of the 1990s is not the first shift in postwar period. Households began shift into stocks in early 1950s and continued to invest heavily in stocks for next 15 years. Four factors combined to end that first Big Shift: war, inflation, financial phobia, demographics.

■ Of these four factors, demographics most likely to bring current Big Shift to an end. *But demographics should not turn negative for about another 15 years.*

■ Shift of capital to mutual funds is *not* a mania and *not* a potentially destabilizing force in U.S. equity market.

■ Big bucks: Individual investors will continue to be big buyers of stocks. This could represent $25 trillion incremental market value over the next 15 years, truly "big bucks" when you consider that the value of the equity market is about $13 trillion today.

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In the fall of 1991 we wrote "The Big Shift—Traditional bank savings move into the capital markets in the 1990s" (September 1, 1991). Two key points were at the heart of that report:

- Traditional brokerage products—stocks, bonds, mutual funds and money markets—made up about $5 trillion of household financial assets in 1991. CDs and other traditional bank savings represented an additional $2.5 trillion. A good part of this $2.5 trillion—equivalent to another 50% of traditional brokerage products—would find its way into stocks, bonds and mutual funds in the 1990s.
- Brokerage products would capture much of this $2.5 trillion because savers, *scared* by financial instability in many banks and S&Ls in the early 1990s and *squeezed* by a dramatic decline in CD rates, would look for a better place to invest those traditional savings.

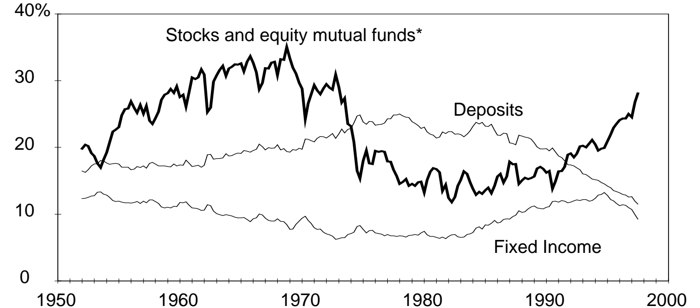
Then, in the spring of 1992, we published "The Ozzie and Harriet Market—The 'Big Shift' turns to equities" (March 20, 1992). In expanding our earlier report, we argued that, driven by long-term education and retirement needs as well as a continued low inflation and interest rate environment, individual investors in the 1990s would be big buyers of stocks, just as they were in the 1950s. Consequently, over time, the percentage of household assets in stocks could rise from the 15% level of the early 1990s back to the 20%+ levels of the 1960s.

The Big Shift is on

The Big Shift in the capital markets in the 1990s has indeed been dramatic. Today deposits at banks account for just 12% of household financial assets, down from a peak of 25% in 1978 and 18% in 1991 (Chart 1). Because of this disintermediation at banks, financial institutions such as brokerages and mutual funds now control almost as much of America's financial assets as do banks (Chart 2). And while, in recent years, savers have again been depositing money in banks—after making withdrawals at the height of the concern about the stability of the financial system in the early 1990s (Chart 3)—those deposits continue to fall as a percentage of Americans' total financial assets. Indeed, the money that in the past went into traditional bank savings products continues to pour into equities so that the percentage of household financial assets invested directly in stocks is 23%, above the 1991 level of 15% and rising toward the 1960s average of 30% (Chart 4).

Chart 1

Households' portfolio allocation of financial assets

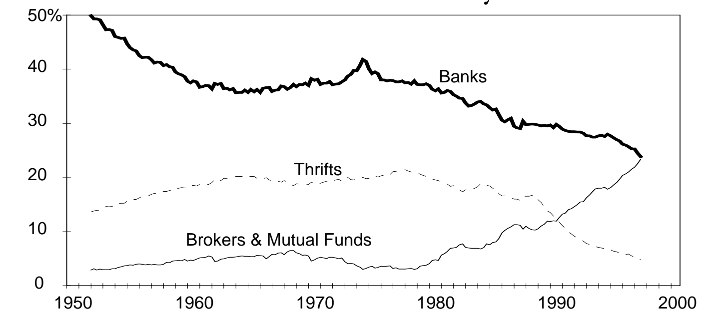


**Includes bank personal trusts, life insurance*

Source: Federal Reserve.

Chart 2

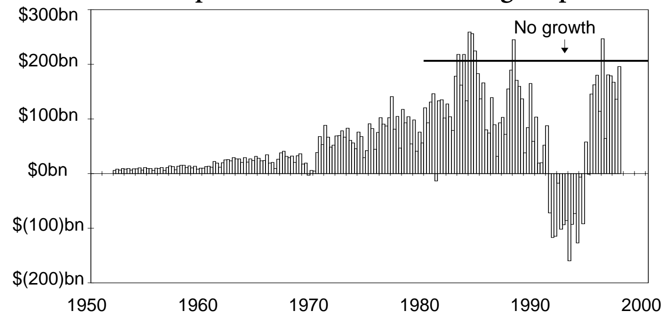
Relative share of total financial intermediary assets



Source: Federal Reserve.

Chart 3

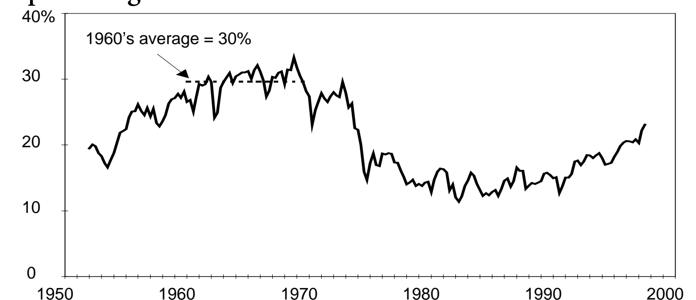
Households' acquisition of time and savings deposits



Source: Federal Reserve.

Chart 4

Direct ownership of equities*
as a percentage of household financial assets



**Includes bank personal trusts, life insurance*

Source: Federal Reserve.

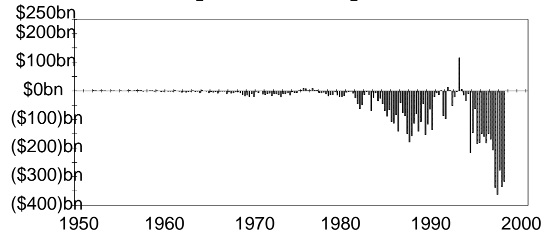
Yet, while the *level* of household financial assets in equities has risen steadily, driven both by households' purchases of equities and strong gains in the stock market in recent years, the Federal Reserve data show that, in the aggregate, there have been consistent net *flows* out of equities by households (Chart 5). And those outflows have *accelerated* in recent years. There are six likely explanations of this apparent inconsistency:

- Corporate share repurchases, which have been strong in recent years, require households to sell stocks to corporations.
- Strong M&A activity. Any time an acquisition is made by another company for cash an individual is selling equity to a non-individual.
- IPOs. Virtually every time a private company goes public an individual will eventually sell some equity in part to a non-individual, i.e., an institution. In other words, an entrepreneur who has just taken his company public will likely sell a small portion of his equity holding in order to, say, build a house or diversify his financial holdings.
- Asset allocation shifts. Rapid stock price appreciation in the past few years has caused household portfolio allocations to equities to skyrocket, so that some households may have sold stocks in order to keep their equity allocations in line.
- Methodological issues. The Federal Reserve's measure of households' acquisition of equity is a residual derived by subtracting from net equity issuance the purchase of equities by various other sectors e.g., mutual funds, pension funds, etc. Obviously, calculating a series as a residual is subject to various measurement errors.
- Finally, mutual funds have turned out to be the vehicle of choice for individuals' participation in the stock market (Charts 6, 7, 8).

But whether households own stocks directly or indirectly—via a mutual fund or in their pension plan—they still own stocks! As Chart 9 shows, households' direct and indirect holdings of equities are now at 43% of financial assets, surpassing the prior 1968 peak of 39%.

Chart 5

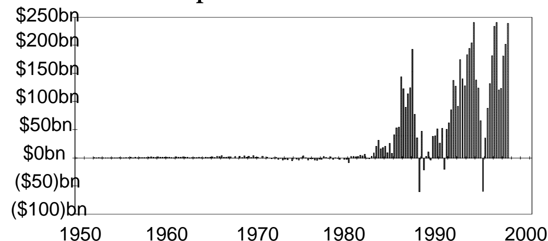
Households' acquisition of equities



Source: Federal Reserve.

Chart 6

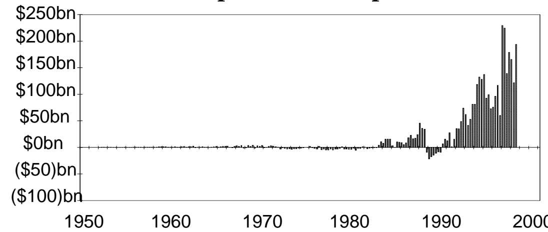
Households' acquisition of mutual funds



Source: Federal Reserve.

Chart 7

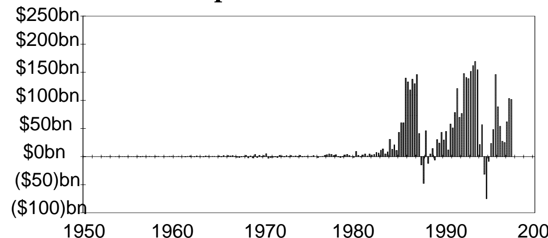
Mutual funds' acquisition of equities



Source: Federal Reserve.

Chart 8

Mutual funds' acquisition of credit market instruments

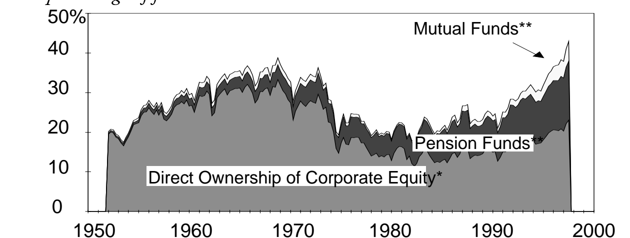


Source: Federal Reserve.

Chart 9

Households' total ownership of equities

as a percentage of financial assets



**Includes bank trusts, life insurance **Equities in mutual funds, pension funds*

Source: Federal Reserve.

What next?

All of the factors behind the Big Shift into equities will remain in place for the foreseeable future.

Interest rates should stay low and trend even lower, further reducing the attractiveness of traditional bank savings products

While yields will not move down in a straight line, the secular decline in interest rates that began in 1982 has yet to run its course. We continue to believe that long-bond yields will reach the 5% level by the turn of the century, or even earlier (see "Five at the Turn," March 31, 1993). Several powerful secular forces will drive interest rates lower over the next several years. The elimination of the federal budget deficit is a key positive for real interest rates. And, as we discuss below, several factors will keep inflationary pressures subdued.

Today a three-month bank CD pays around 4.1%. A person in the top tax bracket will earn an after-tax yield of about 2.5%. With inflation running at a 1.7% rate, that investor's real after-tax yield is just 0.8%. If short-term rates decline by 100 basis points (a not unlikely scenario given that our Asset Allocation model gauges that, relative to long-term rates, T-bill yields are 110 basis points too high versus normal historical spreads), and everything else remained unchanged, investors would earn a *negative* real after-tax return on money in the bank!

Inflationary pressures will remain subdued, supporting P/Es and maintaining the attractiveness of equities

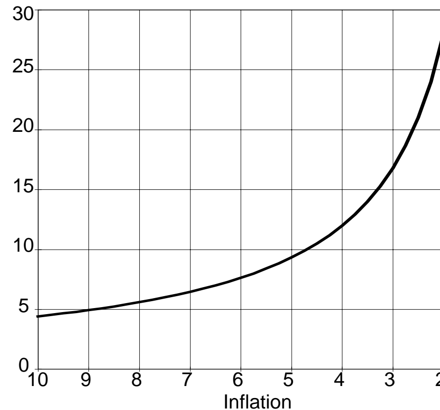
As mentioned, a key factor in the low and declining rate environment is subdued inflation. Helping keep inflation low:

- Still ample global capacity. In addition, the turmoil in Asia will lead to an increased supply of commodities on world markets as producers in these countries export to offset a slump in domestic markets.
- Destimulative global fiscal policies. The U.S. budget deficit has been eliminated and is unlikely to reappear thanks, in large part, to declining defense spending following the end of the Cold War. And, in Europe, preparation for European Monetary Union requires contractionary fiscal policies.
- The productivity revolution proliferates. The most recent data show that in Q3 1997 productivity in the U.S. manufacturing sector surged 9.3%.

As well as keeping interest rates low and reducing the attractiveness of fixed-income alternatives, subdued inflation helps support stock P/Es (Chart 10). Falling inflation causes P/Es to expand because the value of future earnings is increased as they are discounted back to the present at a lower discount rate.

Chart 10

S&P 500 P/E versus inflation



Source: PaineWebber

Baby boomers will continue to worry about funding their children's college education as well as their own retirement needs

As they have grown older, baby boomers have become more discriminating as to how they spend their money—both by choice and out of necessity. Having already "done this" in their 20s and "bought that" in their 30s, it takes a lot more to impress them in their 40s. But now with their children about to head off to college and retirement staring them in the face, boomers are obliged to focus on exactly how they will fund these two major life-cycle events.

Table 1 illustrates the "kids' college education" problem. A parent with one child going to a private college five years from now is expected to have to pay out almost $30,000 per year for four years in education and living costs. And if another child goes to a private college two years later, that will entail *another* $32,000 per year.

In addition, Table 2 shows the magnitude of the retirement savings challenge facing many baby boomers. It shows, for example, that for a 40-year old to retire in 20 years and enjoy a pretax retirement income of $60,000 in today's dollars then—and assuming that person currently has no funds saved for retirement—she will need to invest $47,166 *annually* in order to have the $1,387,668 saved by age 60 that will generate the desired post-retirement income.

Table 1

Projected four-year cost of college education

Years Until College	School Years (Fall)	Projected 4-year cost (Private)	Projected 4-year cost (Public)
1	1998	$96,957	$45,569
2	1999	101,805	47,847
3	2000	106,895	50,239
4	2001	112,240	52,751
5	2002	117,852	55,389
6	2003	123,745	58,158
7	2004	129,932	61,066
8	2005	136,428	64,120
9	2006	143,250	67,326
10	2007	150,412	70,692
11	2008	157,933	74,226
12	2009	165,830	77,938
13	2010	174,121	81,835
14	2011	182,827	85,296
15	2012	191,968	90,223
16	2013	201,567	94,734
17	2014	211,645	99,470
18	2015	222,228	104,444
19	2016	233,339	109,666
20	2017	245,006	115,150

Source: T. Rowe Price Associates Inc.

Table 2

Annual amount of savings needed to generate various post-retirement incomes

# of years to	Annual Pretax Retirement Income from age 60 to age 90				
retire at age 60	$50,000	$60,000	$70,000	$80,000	$90,000
5	$213,999	$256,798	$299,598	$342,398	$385,198
10	96,838	116,206	135,574	154,941	174,309
15	58,253	69,904	81,554	93,205	104,856
20	39,305	47,166	55,027	62,889	70,750
25	28,206	33,847	39,488	45,129	50,770
30	21,023	25,228	29,432	33,637	37,842
35	16,072	19,286	22,500	25,714	28,929

Assumptions: 7% pre-retirement investment return; 5% retirement investment return; 3% inflation.

Source: PaineWebber.

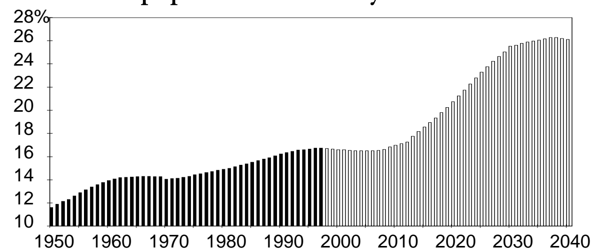
Concerns about the stability of the financial system have been replaced by fears about the adequacy of the Social Security system

A key reason why many baby boomers have already started to save heavily for retirement is a widespread fear that the Social Security system will be insolvent before most boomers retire. The U.S. operates a pay-as-you-go system of social security with each generation of retirees being supported by the contributions of the working population in the form of social security taxes.

Consequently, the system places the onus of payment on current workers. But with a large segment of the population set to retire in the next 20 to 30 years, and with people today living longer than they ever did before, the burden on the system is growing steadily (Chart 11). For example, in 1960 there were five employed people for every social security recipient; today there are three workers for every retiree; but by the year 2040 there will be just two employed people for every social security recipient (Chart 12).

Chart 11

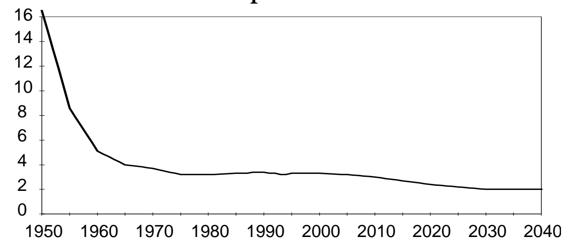
Percent of population over 65 years old



Source: Bureau of the Census.

Chart 12

Number of workers per retiree



Source: OASDI Trustees Report.

Further, while the Social Security trust fund that collects the taxes currently receives more in contributions than it pays out in benefits, it "invests" the surplus in government bonds. This social security "surplus" is, however, a fiction because it is used by the government to finance its other spending programs. In other words, if the fund ever wanted to get back the principal on its holdings of Treasury bonds, the government would have to borrow or make massive spending cuts.

President Clinton, in his recent State of the Union address, proposed that future government budget surpluses be set aside until a solution is found to the looming insolvency of the Social Security system. However, the President did *not* propose any specific ways to prevent the Social Security system from becoming insolvent. Rather, he said he would lead public meetings around the country this year to discuss why Social Security has to be changed and to stimulate debate over which of a host of options would be best.

If the expected budget surpluses totaling $1 trillion over the next ten years are allocated to shoring up Social Security, that could postpone the system's insolvency for ten years. But even though President Clinton *proposed* setting aside *expected* future budget surpluses, this may not actually happen. State of the Union speeches are wish lists, especially when both houses of Congress are controlled by the Republicans who have no real incentive to go along with the President.

Don't do as I say

To be fair though, when it was created by President Roosevelt in 1935, the Social Security system was intended to act *only as a safety net* for the elderly—in the 1930s, the poverty rate among the elderly was up to three times that of the population as a whole. Social Security was supposed to be the safety-net "leg" of the proverbial "three-legged retirement stool," with the other two legs being personal savings and pension income. Today, many apparently still do not appreciate this insurance-policy aspect of the system. Even though surveys consistently reveal that a majority of respondents say they are not confident that Social Security will survive long enough to benefit them, the actions of millions of Americans indicate that they regard Social Security not just as a safety net, but as their sole source of post-retirement income:

- According to the Federal Reserve's most recent *Survey of Consumer Finances,* 45% of families in the U.S. do not save any of their income. Further, the propensity to save rises with wealth so that, for example, middle-class families who need to save for retirement are *less* likely to do so than wealthy families (Chart 13).

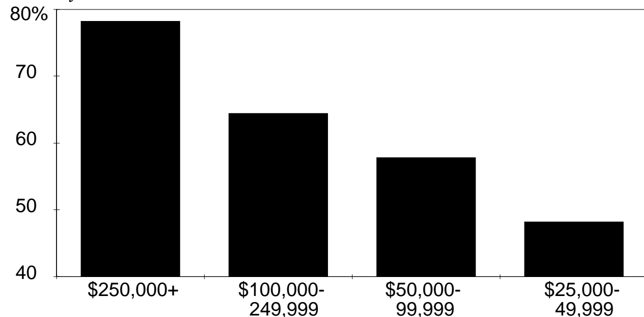
- The *Survey* also reveals that 60% of families are not covered by any type of employer-sponsored pension plan. Of those who are covered, the percentage of families covered by defined-benefit plans has fallen sharply, reflecting the decline in the number of companies offering defined-benefit pension plans (Chart 14). And while participation in 401(k)-type plans is voluntary, *more than one-quarter of family heads who are eligible to participate in such a plan fail to do so.*

- Although the percentage of families with retirement accounts has risen strongly in recent years, the median value of families' holdings in retirement accounts was just $15,600 in 1995, virtually unchanged from the 1992 level of $15,200.

Chart 13

Percentage of families that save

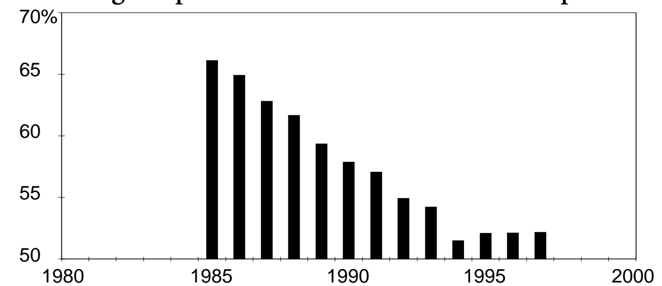
sorted by net worth



Source: Federal Reserve.

Chart 14

Percentage of pension assets in defined benefit plans



Source: Employee Benefit Research Institute.

While it seems likely that the Social Security system will eventually be reformed so that some contributions will be invested in earning assets, it would be reckless to assume that Social Security will ever be anything more than a safety net. So the fact remains that Americans will continue to have to plan for the bulk of their retirement income by themselves.

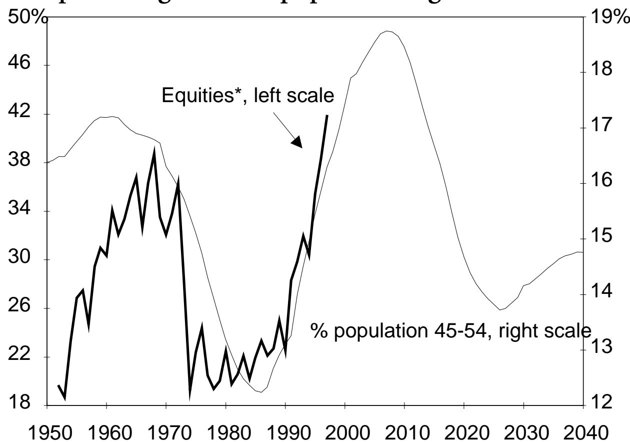
The second Big Shift

The Big Shift into equities that started in the early 1990s is clearly in full swing. And while a further *dramatic* shift in households' portfolio allocations seems unlikely, the four factors discussed above—low interest rates, subdued inflation, education and retirement needs and the inadequate Social Security system—should ensure that households continue to invest a significant portion of their financial assets in equities, just as they did in the 1950s and early 1960s.

As we discussed in "The Ozzie and Harriet Market," the portfolio shift of the 1990s was not the first such shift in the postwar period. Households also began a shift into stocks in the early 1950s and continued to invest a significant portion of their financial wealth in stocks for about the next 15 years (Chart 15).

Chart 15

Stocks as a percentage of household financial assets, and percentage of U.S. population aged 45-54



** Includes bank personal trusts, life insurance, mutual funds, pension funds.*

Source: Federal Reserve, Bureau of the Census.

The drivers of that first Big Shift were:

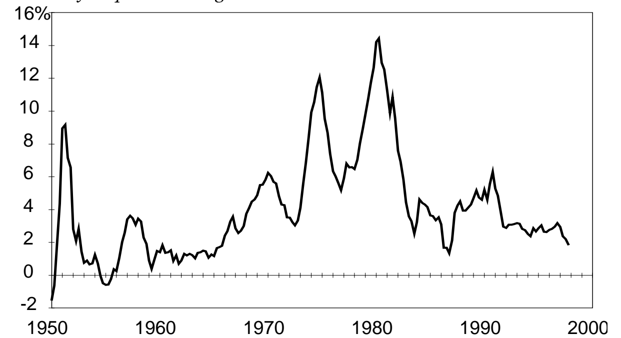
- Low interest rates at banks. Banks and S&Ls were permitted to pay savers no more than 2.5% until 1957, when the rate was jacked way up to 3.5%.
- In the low inflation environment (Chart 16), T-bill yields in the 1950s averaged just 2.1% (Chart 17).
- As for bonds, they were only slightly more enticing; the yield on 10-year bonds averaged 2.7% in the 1950s (Chart 18).
- Real estate was not an attractive investment option either. Although land prices crept upwards in the 1950s and 1960s, housing prices did not surge because, while demand for housing was rising rapidly, so was supply.
- Finally, as Chart 15 illustrates, the 45- to 54-year-old age group was a large and growing segment of the population in the 1950s. After the hardships of the Great Depression and World War II this group, now in their peak income years, spent their money prudently and were steady, faithful savers.

So with bonds, cash and real estate offering unappealing returns, that left stocks as the best investment—a frightening thought for many investors in the early 1950s, many of whom vividly remembered the 1929 stock market crash. Not surprisingly then, the bull market of 1952-66 was an extremely cautious one. For a start, the stock market was heavily regulated by the Fed and the SEC—margin requirements were kept well above 50%, sometimes as high as 90%. And individual investors did not own stocks to make a killing, but rather as a long-term investment.

Chart 16

Inflation

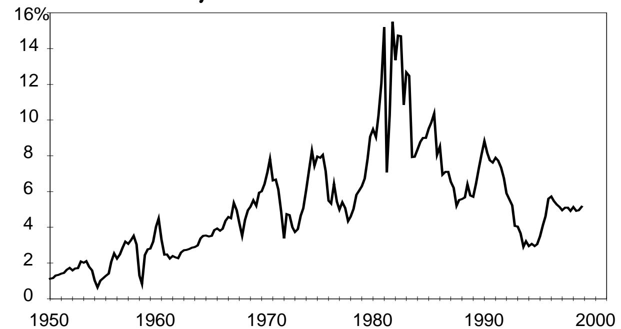
Year-to-year percent change in CPI



Source: Bureau of Labor Statistics.

Chart 17

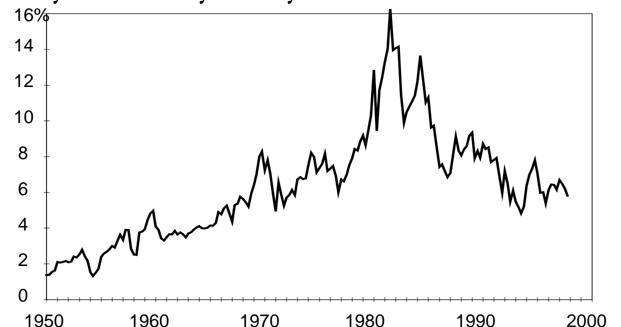
3-month T-bill yield



Source: Federal Reserve.

Chart 18

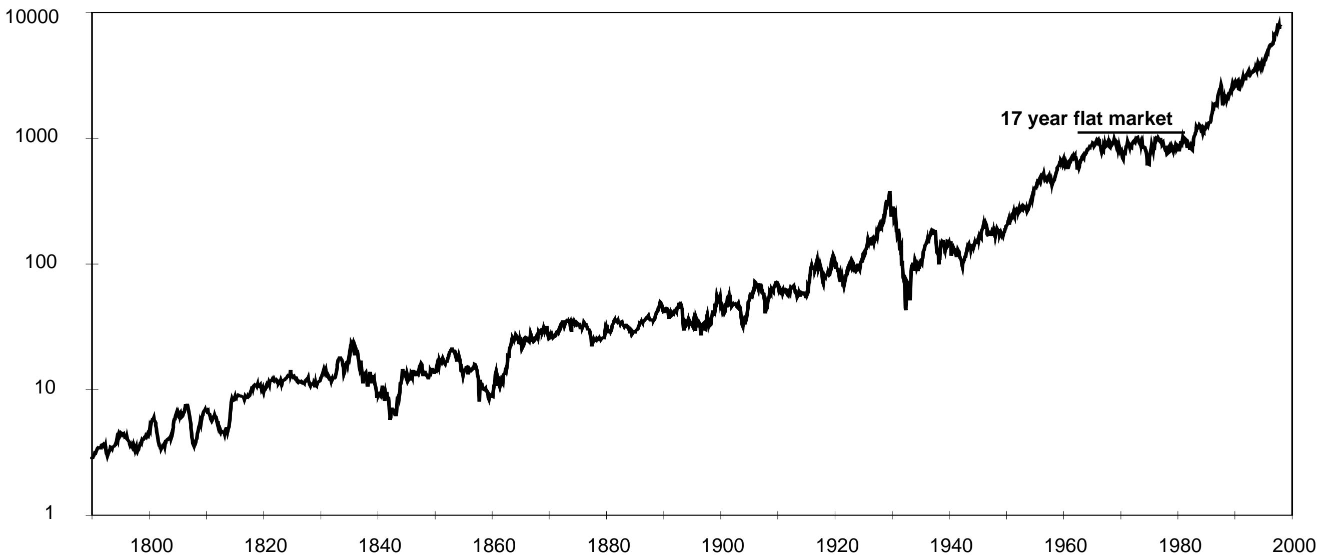
10-year Treasury bond yield



Source: Federal Reserve.

Chart 19

Dow Jones Industrial Average 1790-1998



Source: PaineWebber.

The end of the first Big Shift

The great post-World War II bull market ran from 1952 to 1966. At the beginning of 1952 the Dow Industrials stood at 269; in January 1966, it hit 1000—a level that would not be substantially exceeded until 1983 (Chart 19). And, after their peak in 1968, stocks would not account for as large a portion of household financial assets for another 30 years—i.e., until today (Chart 9). Four factors combined to end the first Big Shift into stocks in the postwar period.

War

LBJ attempted to fight both the war on poverty (which included a new program called "Medicare") and the war in Vietnam without raising taxes—even though the unemployment rate was only 4.4% in 1965. With the economy already booming, the twin wars against poverty and Ho Chi Minh engendered secular inflation which killed the bull market.

Inflation

Rising inflation produced higher interest rates and lower P/E ratios and hurt corporate earnings because it led to credit crunches (1966), price controls (1971) and recession (1970). Then food prices soared during 1973 and, in the winter of 1973-74, OPEC quadrupled the price of gasoline. Inflation rose above 10% in 1973, and stock prices collapsed 45% from their 1973 peak to their 1974 low. This was not just another "bear market" but a veritable financial revolution. While stock prices were collapsing, the price of everything else soared. Therefore, stocks as a percentage of household assets plunged from 36% in 1972 to 19% in 1974 (Chart 9). They stayed near that level for the next two decades.

After the 1975 recession, inflation got worse and worse. From 1977 through 1980, the newspapers were full of stories about the failures of the Carter Administration's various schemes for containing inflation, and gloomy news about their lack of success. Stocks obviously were not the place to invest during this period of runaway inflation; in 1978, the DJIA was no higher than in 1966, even though the cost of living had doubled.

Financial phobia

Despite the severe recession of 1981-82, conditions began to improve in 1981. In his first few weeks in office, President Reagan got the hostages back from Iran and smashed the air traffic controllers' union. Inflation came way down in 1982 and federal income taxes were cut in 1983 just as the economy began to recover. But even though the market tripled in the 1980s, just as it did in the 1950s, individual investors largely ignored stocks. There were several reasons why:

- Most important, you didn't need stocks to beat inflation because money market funds and bonds did the trick with much less risk and less hassle (Charts 17, 18).

- Another reason to steer clear of stocks was that, given their dismal record of the past 15 years, they seemed just too risky.
- And to judge from the newspapers, Wall Street was rife with insider trading. It appeared that the small investor didn't have a good chance of playing the takeover game when Wall Street arbitrageurs had the inside scoop on who would be "taken out" next.
- Worse still was program trading. You never knew when the market would dive, costing small investors real money. Wall Street just did not seem an appropriate place to invest for retirement.
- Then there was the 1987 crash, when the DJIA dropped 23% in one day and 30% in three months.

To the extent that individual investors were willing to invest in long-term assets, they preferred bonds to stocks. In the period 1982-89, mutual funds' net purchases of bonds were nearly five times greater than net purchases of stocks (Charts 7, 8). As for equities, their share of households' financial assets did not rise much, averaging just 22% in the 1980s (Chart 9).

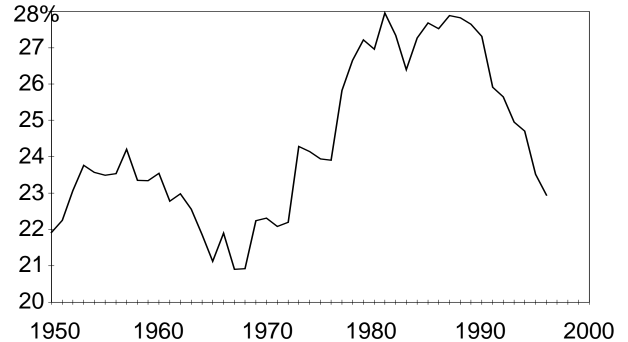
Demographics

As Chart 15 illustrates, the share of household assets in stocks follows fairly closely the share of the population aged 45-54 ("the savers"). Both shares peaked in the early 1960s and then began declining. The shift out of stocks then accelerated in the early 1970s because of the aforementioned inflation. The portfolio shift would have continued anyway, however, as the baby boomers ("the spenders") started to enter the labor force in the 1970s, and then turned 30 in the 1980s—the decade when conspicuous consumption, rather than prudent saving, was *de rigeur*.

One notable characteristic of this period was the shift to real estate. Indeed, borrowing in order to buy real estate was perhaps the key characteristic of the 1980s. Reflecting this, real estate's share of total household assets rose by seven percentage points between 1967 and 1986 (Chart 20), mostly because of bigger holdings of vacation homes and investment properties.

Chart 20

Real estate as a percentage of total household assets



Source: Federal Reserve.

15 more years

While the same factors that motivated the first Big Shift into equities in the 1950s and 1960s are at work again today, the conditions that brought the first Big Shift to an end in 1966 are unlikely to reappear any time soon.

War

The risk of a war that ushers in a bear market is low but not negligible. On the one hand, given that the Soviet Union has collapsed and America's relations with China have improved markedly, the likelihood of a full-scale nuclear exchange is very low.

On the other hand, there is a definite risk that the U.S. could be sucked into a regional conflict. Saddam Hussein remains bellicose, Iran may or may not be seeking a détente with the U.S., Israel's relations with other countries in the Middle East are still volatile and, with thousands of U.S. troops on the ground, the former Yugoslavia could potentially become tomorrow's Vietnam. But while there has been speculation that the U.S. may launch an attack against selected sites in Iraq, it is unlikely that such military action—or military action in any of the world's other potential hot spots—would escalate into a conflict of the magnitude of Vietnam, or even Desert Storm in 1991.

Inflation

Ample global capacity, destimulative global fiscal policies and strong productivity gains should ensure that inflationary pressures remain subdued for the foreseeable future. In addition, in contrast to the 1970s there is much less risk of "cost-push" inflation because of weaker unions and greater foreign competition—imports today account for almost one-third of total domestic consumption versus just 14% in 1976.

Financial phobia

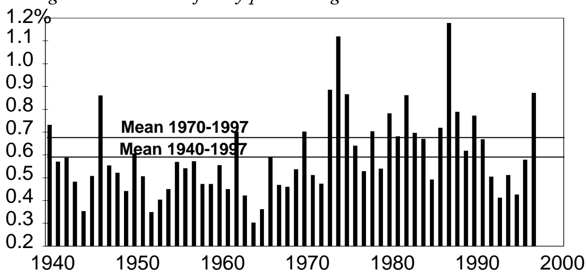
As we saw, what kept many individual investors away from equities in the 1980s was the perception that the stock market was risky, rigged and relatively unattractive in comparison to the fixed-income alternatives.

While equities, like all investment classes, will always contain an element of risk, stocks have been less volatile in the 1990s than they were in the 1980s. We pointed out in "The New Market Volatility" (September 7, 1997) that in the 1990s the market has had "five consecutive years of below-average volatility (1992-1996)" (Chart 21). That is *not* to say that there has been a secular decline in market volatility in the 1990s—in fact, volatility in 1997 was well above average and comparable to the volatility observed during much of the 1980s. But the post-1987 introduction of daily price limits by the stock exchanges, as well as the muted business cycle—fewer booms, fewer busts and more "soft landings" (see "A Muted Business Cycle," July 21, 1996)—likely means that volatility will remain close to historical average levels, rather than well above those levels as was the case in the 1980s. And individual investors actually have learned from their experiences in 1987, 1989 and 1997 that when unusual volatility in the market produces big, quick corrections, that has been a good time to buy.

Chart 21

DJIA volatility

average absolute value of daily price changes



Source: PaineWebber.

As well as a return to more normal levels of market volatility, the 1990s have seen far fewer high-profile insider trading cases, likely reflecting regulatory success in clamping down on illegal activities. Overall, there is much less suspicion that the market is rigged and that Wall Street arbitrageurs have the inside scoop at the expense of "the small guy."

Finally, perhaps the biggest difference in the investment environment of the 1990s versus the 1980s is the relative unattractiveness of money market funds and other short-term instruments. Investors were not being entirely irrational in choosing the relative security of T-bills—which yielded 9.2% on average during the 1980s—when stocks had been such terrible investments for much of the 1970s. But today, with short-term rates already low and likely heading lower, stocks are a much more appealing investment.

Demographics

As we saw, in the early 1970s the shift out of stocks accelerated because of inflation, but that shift would have occurred anyhow, as the young baby boomers thronged the labor force and spent more heavily than they saved. Of the four factors that brought the first Big Shift to an end, the demographic factor is the most likely to bring the current Big Shift to an end. *But demographics should not turn negative for about another 15 years.* The percentage of the population that is 45-54 should reach a peak of 18.7% in 2007, and then stay close to that peak level for the next five years (Chart 15). And note that back in the 1960s, *the percentage of household assets in stocks continued to rise even after the share of 45- to 54-year-olds in the population had started to turn down.* If the share of household assets in stocks follows the relationship suggested in Chart 15 (the share of household assets in stocks tracks fairly closely the share of the population aged 45-54), then the share of households' financial assets in stocks should go higher than current levels.

A mania?

As we have seen, indirect equity ownership through mutual funds has become the preferred method of individuals' participation in the stock market. However, some observers insist that the flood of money into mutual funds is a dangerous new mania—equity mutual fund inflows averaged $19 billion a month in 1997, compared with less than $2 billion a decade ago. One does hear horror stories about fund holders who think their fund is Federally insured, or that rising interest rates are bullish for bond prices. No doubt it is true that there are a few fund holders who could not pass the CFA exam. But far from being a mania, the shift of capital to mutual funds strikes us as a very rational move, and one that is *not* a potentially destabilizing force in the U.S. equity market:

- Given the level and direction of interest rates, equities are a better investment alternative than bonds or cash—particularly for the long-term investor who is

saving for retirement and whose tax rate is much lower on capital gains than on interest income.

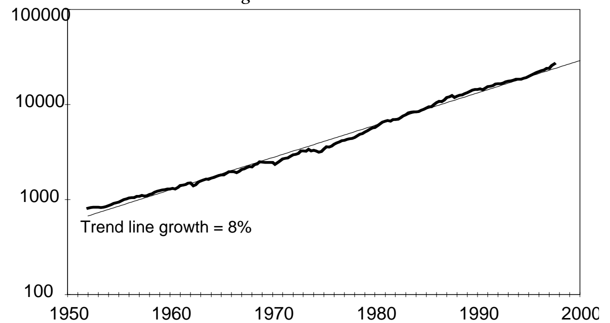
- The preference for a diversified portfolio of mutual funds mitigates (but does not eliminate) the riskiness of stocks. By pooling the resources of many investors, these funds enable individuals to invest in many different securities.
- Individual investors have shifted to equities to save for retirement, *not* because of short-term speculation.
- Individual investors are not novices. Many have been investing in equities since the 1980s, and the 1987 stock market crash—and other subsequent corrections—has taught them the risks involved.
- Today's investors are neither young nor uneducated. The NYSE, in its most recent annual *Fact Book*, states that the median age of shareholders is 45 and almost half have college degrees.

Based on the experience of the 1950s and 1960s, there is little reason to believe that investors will indiscriminately dump their mutual funds in a down stock market. In the market declines of 1962, 1966 and 1970, mutual funds were in each instance net sellers of equities for only a single quarter and only at an annual rate of $0.5 billion or so. This was a moderate amount of liquidation that compared with annual net purchases of $1-2 billion during the preceding two years.

Over the years, mutual fund investors have shown themselves to be fairly shrewd. They were buyers in the 1960s but heavy sellers in 1972, prior to the 1973-74 market disaster, and they continued to sell throughout the inflationary 1970s, when the real return from equities was poor. With the exception of the post-crash year 1988, mutual funds were net buyers of stock throughout the 1980s and on into the 1990s—including the market decline of 1990 which followed Iraq's invasion of Kuwait. In short, there is little basis for considering mutual funds a destabilizing force in the U.S. equity market.

Finally, one clear sign that individual investors have long term confidence in the stock market is that recent financial market turbulence caused investors to reallocate assets to different sectors of the equity market rather than prompting a full-scale dumping of stocks. For example, financial market turmoil in Asia spurred a transfer out of international mutual funds and into domestic-oriented ones.

Chart 22
Households' financial assets
in $ billions, with trend line growth



Source: Federal Reserve.

Big bucks

Currently, total U.S. households' financial assets in stocks—via direct ownership, mutual funds and pension funds—approaches $12 trillion (with the other $1 trillion of U.S. equities owned largely by foreigners).

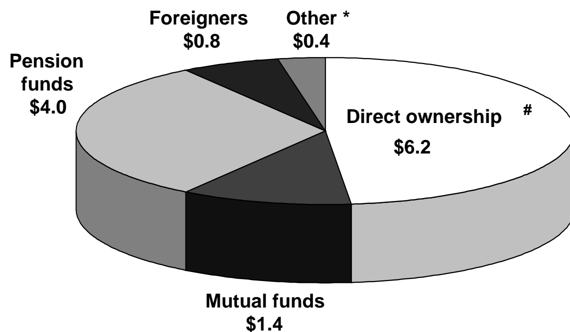
- Assuming household financial assets continue to grow at their historical average 8% nominal rate (Chart 22), and that the percentage of household financial assets in stocks merely holds steady at the current 43%, that would represent $24 trillion incremental market value over the next 15 years.
- And if (as suggested by the relationship in Chart 15—that the share of household assets in stocks follows fairly closely the share of the population aged 45-54) the percent of households' financial assets in stocks rose modestly higher to, for example, just 45%, that would represent $26 trillion incremental market value.

This $24-$26 trillion is truly "big bucks" when you consider that the value of equities (Charts 23, 24) is about $13 trillion today (with about $10 trillion of that in publicly traded U.S. equities, over $1 trillion in holdings of foreign issues by U.S. residents, and another $2 trillion being closely held, nonpublicly traded equities).

Chart 23

Who owns stocks…

(in $ trillions)



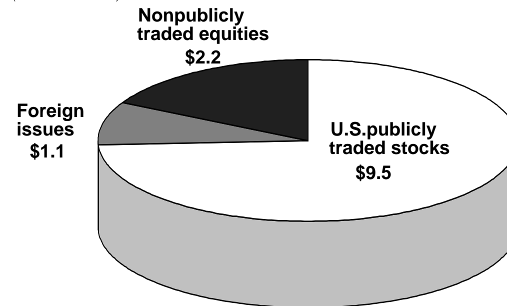
**Brokers & dealers, banks etc.* *#Includes bank personal trusts, life insurance*

Source: Federal Reserve, PaineWebber.

Chart 24

…and what kind of stocks

(in $ trillions)



Source: Federal Reserve, PaineWebber.

Table A1

Household Financial Assets—Then (Q3 ’91) and now (Q3 ’97)

	Q3 1991				Q3 1997			
	Billions of $’s		Percent		Billions of $’s		Percent	
Deposits in Banks and S&Ls		$2,857		18.0%		$3,100		11.5%
Checkable	$388		2.4%		$389		1.4%	
Time Deposits	2,470		15.5		2,711		10.1	
Money market shares		377		2.4		598		2.2
Bonds and Notes		1,568		9.9		1,899		7.1
U.S. Government	501		3.2		880		3.3	
Municipal Bonds	609		3.8		397		1.5	
Corporate and Foreign Bonds	272		1.7		287		1.1	
Other	187		1.2		335		1.2	
Mutual Funds		586		3.7		1,991		7.4
Stocks		2,190		13.8		5,792		21.5
Life Insurance Reserves		402		2.5		639		2.4
Pension Fund Reserves		3,745		23.6		7,296		27.1
Equity in Non-corporate business		3,245		20.4		4,051		15.1
Other		919		5.8		1,531		5.7
Total		$15,888		100%		$26,897		100%

Source: Federal Reserve.

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