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Ten Stock-Market Myths That Just Won't Die

The Dow Jones Industrial Average last week ended up pretty much where it had been a little more than a week earlier. A rousing 200-point rally on Wednesday mostly made up for the distressing 200-point selloff of the previous Friday.

The Dow plummeted nearly 800 points a few weeks ago -- and then just as dramatically rocketed back up again. The widely watched market indicator is down 7% from where it stood in April and up 59% from where it was at its 2009 nadir.

These kinds of stomach-churning swings are testing investors' nerves once again. You may already feel shattered from the events of 2008-2009. Since the Greek debt crisis in the spring, turmoil has been back in the markets.

At times like this, your broker or financial adviser may offer words of wisdom or advice. There are standard calming phrases you will hear over and over again. But how true are they? Here are 10 that need extra scrutiny.

1 "This is a good time to invest in the stock market."

Really? Ask your broker when he warned clients that it was a bad time to invest. October 2007? February 2000? A broken watch tells the right time twice a day, but that's no reason to wear one. Or as someone once said, asking a broker if this is a good time to invest in the stock market is like asking a barber if you need a haircut. "Certainly, sir -- step this way!"

2 "Stocks on average make you about 10% a year."

Stop right there. This is based on some past history -- stretching back to the 1800s -- and it's full of holes.

About three of those percentage points were only from inflation. The other 7% may not be reliable either. The data from the 19th century are suspect; the global picture from the 20th century is complex. Experts suggest 5% may be more typical. And stocks only produce average returns if you buy them at average valuations. If you buy them when they're expensive, you do a lot worse.

3 "Our economists are forecasting..."

Hold it. Ask your broker if the firm's economist predicted the most recent recession -- and if so, when.

The record for economic forecasts is not impressive. Even into 2008 many economists were still denying that a recession was on the way. The usual shtick is to predict "a slowdown, but not a

recession." That way they have an escape clause, no matter what happens. Warren Buffett once said forecasters made fortune tellers look good.

4 "Investing in the stock market lets you participate in the growth of the economy."

Tell that to the Japanese. Since 1989 their economy has grown by more than a quarter, but the stock market is down more than three quarters. Or tell that to anyone who invested in Wall Street a decade ago. And such instances aren't as rare as you've been told. In 1969, the U.S. gross domestic product was about \$1 trillion, and the Dow Jones Industrial Average was at about 1000. Thirteen years later, the U.S. economy had grown to \$3.3 trillion. The Dow? About 1000.

5 "If you want to earn higher returns, you have to take more risk."

This must come as a surprise to Mr. Buffett, who prefers investing in boring companies and boring industries. Over the last quarter century, the FactSet Research utilities index has even outperformed the exciting, "risky" Nasdaq Composite index. The only way to earn higher returns is to buy stocks cheap in relation to their future cash flows. As for "risk," your broker probably thinks that's "volatility," which typically just means price ups and downs. But you and your Aunt Sally know that risk is really the possibility of losing principal.

6 "The market's really cheap right now. The P/E is only about 13."

The widely quoted price/earnings (PE) ratio, which compares share prices to annual after-tax earnings, can be misleading. That's because earnings are so volatile -- they're elevated in a boom, and depressed in a bust.

Ask your broker about other valuation metrics, like the dividend yield, which looks at the dividends you get for each dollar of investment; or the cyclically adjusted PE ratio, which compares share prices to earnings over the past 10 years; or "Tobin's q," which compares share prices to the actual replacement cost of company assets. No metric is perfect, but these three have good track records. Right now all three say the stock market's pretty expensive, not cheap.

7 "You can't time the market."

This hoary old chestnut keeps the clients fully invested. Certainly it's a fool's errand to try to catch the market's twists and turns. But that doesn't mean you have to suspend judgment about overall valuations.

If you invest in shares when they're cheap compared to cash flows and assets -- typically this happens when everyone else is gloomy -- you will usually do very well.

If you invest when shares are very expensive -- such as when everyone else is absurdly bullish -- you will probably do badly.

8 "We recommend a diversified portfolio of mutual funds."

If your broker means you should diversify across things like cash, bonds, stocks, alternative strategies, commodities and precious metals, then that's good advice.

But too many brokers mean mutual funds with different names and "styles" like large-cap value, small-cap growth, midcap blend, international small-cap value, and so on. These are marketing gimmicks. There is, for example, no such thing as "midcap blend." These funds are typically 100% invested all the time, and all in stocks. In this global economy even "international" offers less diversification than it did, because everything's getting tied together.

9 *"This is a stock picker's market."*

What? Every market seems to be defined as a "stock picker's market," yet for most people the lion's share of investment returns -- for good or ill -- has typically come from the asset classes (see No. 8, above) they've chosen rather than the individual investments. And even if this does turn out to be a stock picker's market, what makes you think your broker is the stock picker in question?

10 *"Stocks outperform over the long term."*

Define the long term? If you can be down for 10 or more years, exactly how much help is that? As John Maynard Keynes, the economist, once said: "In the long run we are all dead."

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