3Qs: Expert weighs in on how to play a bull market

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The Dow Jones industrial average reached a record high on Tuesday, erasing all of the losses suffered in the Great Recession of 2008-2009. But many investors have ignored the stunning surge in stocks, surprising money managers of prominent firms. Credit: Thinkstock

The Dow Jones industrial average reached a record high on Tuesday and continued rising throughout the week, erasing all of the losses suffered in the Great Recession of 2008–2009. But many investors have ignored the stunning surge in stocks, surprising money managers of prominent firms, one of whom noted that he doesn't understand why "people don't want to play." Northeastern University news office asked Paul Bolster, an expert in portfolio management and the Donald F. Harding Professor of Finance and Insurance, to explain how you should play the Dow's third strongest bull market since World War II.

The Dow surged and corporate profits skyrocketed, but hourly wages have stagnated and many middle-class Americans are still mired in the worst labor-market recovery since World War II. What role do high stock prices play in the country's overall economic future?

The stock market typically serves as a leading indicator for the overall economy. Higher investment returns in the stock market will encourage more investors to come off the sidelines to exploit the potential for high returns. This will encourage corporations to pursue growth options, which should lead to further economic growth. But the point that many Americans are not seeing any material benefit from this development is fair. During the financial crisis of 2008, many corporations cut expenses to reduce losses or to preserve profits. This is why the unemployment rate increased so quickly at that time. What many corporations discovered was that they could operate very well with a smaller payroll. This increase in operating efficiency is one major reason why corporate profits are now so robust. We are finally beginning to see sustained but modest increases in employment levels. If the stock market were still languishing, it would be a much less optimistic economic outlook.

The founder of one investment research firm pointed

out that the four-year bull market has entered its final stage, a historically profitable one, with average gains of 38 percent. How should a young investor who wants to play the market for the first time allocate his assets in order to maximize his earning potential? What about a returning investor who fled the market and clung to low-yielding assets such as cash and bonds?

Investing now is good idea. Since 1926, the annualized return on U.S. stocks is 9 percent, which I would be thrilled with. A new investor should focus on two things: risk and time. I can't promise a positive return. However, I can reduce the probability of a significant loss. Identify a diversified mutual fund with low expenses. Mutual funds offer professional management and risk reduction through diversification. Maintain a long-term perspective. Invest a modest amount to get started and as you get comfortable with the risk, add to your investment on a regular basis.

I know many investors holding cash and bonds right now. These investors got burned by the 40 percent drop in stock values and got out. It's all about asset allocation. They need to decide if they are willing to take more risk to capture potentially higher returns. Most investors would benefit from a reasonable allocation to U.S. equities over a longer time horizon. I'd encourage these folks to invest in stocks but at a more modest allocation than they had back in 2008. As time passes, this allocation can be increased while also being tempered by the pain of their past experience.

Eighty percent of stocks are held by the wealthiest 10

percent of households. Is now the perfect time for middle-class Americans to rekindle their relationship with the stock market?

Yes, but it is easier to say than to do. The reason that wealthy households hold so much stock is because they know the returns from the market can be very rewarding, but more important, they can stomach the significant risk of loss that comes as part of the package. Middle-class Americans don't always have the capacity to take on this downside risk. But those who can save on a regular basis, whether for retirement or another objective, should benefit from allocating part of their savings to the stock market. You need to be disciplined and maintain a long-term perspective.

Provided by Northeastern University

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