Where to Put Your Money Now

The higher the stock market climbs, the harder it is to score big gains. You may find better opportunities abroad.

BY ANNE KATES SMITH

AS THIS BULL MARKET HEADS DEEPER into its seventh year—a remarkable feat accomplished only three other times in the past 85 years—investors have every right to reevaluate their strategy. Is it time to defend your portfolio against the long list of challenges that could finally best an aging bull? Or should we continue to bet on the resilience of a stock market that has time and again punished non-believers? In other words, what are we dealing with here? A super bull? Or one on its last legs? We’re not ducking the question when we say it’s a little of both. We’re basically sticking with our forecast that Standard & Poor’s 500-stock index
will finish 2015 at about 2200 (equivalent to roughly 19,000 for the Dow Jones industrial average), though what seemed conservative in January may appear a touch optimistic today. Taking into consideration the stock market’s average dividend yield of 2%, that implies that investors could see a total return of 9% for the year. (The S&P 500 and the Dow closed at 2108 and 18,024, respectively, on May 1; all prices and yields are as of that day.)

That’s a more modest advance than we’ve become accustomed to; the market has returned nearly 23% a year on average since the bull market began in March 2009. And gains might not come easily. “We envision a grind-it-out year,” says Chris Hyzy, chief investment officer of U.S. Trust. “The light is green—not yellow or red, but not an all-systems-go green, either.”

Investors will do best in this market by being tactical. That means picking up bargains on down days or using rallies to pare back your stock holdings (see the box on page 49). In general, we favor stocks over bonds and see increasing opportunities overseas. By no means should you abandon U.S. stocks, but being more defensive—favoring large-capitalization stocks over smaller-cap fare, for example—might be in order. You may also want to focus on companies that will benefit from a stronger economy. (For more strategy, see the interview at right.)

Having a plan helps when the going gets rough. The stock market was relatively placid in 2013 and for most of 2014, but increasing volatility has unnerved many investors. “Stocks are priced for perfection, with a margin of error that continues to narrow,” says Terry Sandven, chief stock strategist at U.S. Bank. “That explains the volatility.” He predicts that stocks will be buffeted by the economic statistic du jour, giving investors plenty of opportunities to buy on dips. Stocks have not seen a correction (generally defined as a decline of 10% to 20%) since 2011, although they usually occur an average of every two years.

“Any weakness is a pause that refreshes and resets—not the start of a prolonged bear market,” Sandven says.

A key issue for stocks is whether corporate earnings can get back on track. Last fall, analysts were estimating double-digit-percentage profit growth for 2015. But following a collapse in oil prices and a surge in the dollar, they slashed their forecasts. Strategists at Bank of America Merrill Lynch, for example, expect profits for companies in the S&P 500 to decline by 1% this year, primarily because of the 45% drop in oil prices and the 20% increase in the value of the dollar since June 2014. If they’re right, the S&P 500 will log its first annual earnings decline since 2008. Excluding those two factors, BoA estimates that profits would be up 10% this year. (The table on page 48 shows how profit growth has tracked stock market returns over the past 10 years.)

Analysts, who are often accused of wearing rose-colored glasses, may think prices are stretched, you’ve got to have more modest expectations for annual returns over the next five years—probably in the mid-single-digit percentages, including dividends.

**Q&A WITH RUSS KOESTERICH**

**Modest Gains, More Volatility**

Russ Koesterich is global chief investment strategist at BlackRock, an investment firm with $4.8 trillion under management.

**How much life is left in this bull market?**

Stocks can go higher, but that is likely to happen with more volatility. I think the bull market will celebrate its seventh anniversary next March, and the next bear market can be pushed out to later in 2016 or 2017. But the risk will go up as the Federal Reserve Board continues to normalize monetary policy and investors lose that pillar of easy money propping up financial assets.

**When do you expect the Fed to raise rates?**

The Fed will start to nudge rates higher in the fall. It won’t be the end of the world; the Fed will move at a slow and measured pace, and it’s starting from a very low rate. But the odds of a correction go up the closer we get to liftoff.

**Are stocks overpriced?**

Valuations are stretched—not obscenely so, but a bit above average. U.S. stocks are also expensive compared with those in markets outside the U.S. Whether you call stocks fully valued or just

**Should investors take some money off the table?**

In this environment, it’s reasonable to hold more cash. The problem is that this has become a semi-permanent position for many people who never came back after the trauma of the last bear market. Holding a lot of cash yielding zero is a hard way to save for retirement.

**Where do you see opportunity?**

Prices in Japan are reasonable. Gains there have been driven by earnings growth, not by investors paying more for those earnings, as has been occurring here and in Europe. We still see opportunities in Europe, but you should look for a fund that hedges out all or most of the currency risk. People got frightened away from emerging markets, but there have been some promising reforms, and those parts of the world will grow quickly. People should exercise caution with emerging markets, not practice abstinence.
have overdone the gloom and doom this time. As of early May, 68% of S&P 500 companies that had reported first-quarter earnings beat analysts’ lowered expectations; 63% do so in a typical quarter. Plus, the dollar and oil prices have stabilized recently, and we believe the biggest moves are behind us. With companies having adjusted for the price swings already, earnings comparisons with year-ago periods will start looking up, and investors will begin to anticipate better earnings growth in 2016. “Underlying revenue and earnings growth that’s pretty darn good is being temporarily obscured by the dollar,” says Matt Berler, CEO of Osterweis Capital Management. As for oil, he adds, if the first consequence of lower prices is a drop in energy profits, the second and more important effect is the boost that cheaper energy gives the global economy. “In the U.S., a quick hit to economic growth and earnings will translate into a positive as the consumer spends that energy dividend,” he says.

For now, though, stock market bulls must look past lackluster economic growth early in 2015. After generating 2.2% growth in the fourth quarter of 2014, the economy stalled in the first quarter of this year, performing far worse than expected.

Blame much of the drag on dollar-induced trade woes and spending cuts in the oil patch. Making matters worse, labor strikes at West Coast ports worsened the trade deficit, and...
a brutal winter sent shoppers into hibernation. A build-up in inventories that contributed to growth in the first quarter will have to be worked down in future quarters, pressuring GDP.

The economy should bounce back in the second half of the year, buoyed by a strengthening housing market and improving consumer spending. But the poor early showing will curtail U.S. growth for the full year. Kiplinger now expects real GDP growth of 2.6% in 2015, though the economy may surprise us with its vigor.

**THE FED GUESSING GAME**

The recent economic uncertainty has Federal Reserve watchers wondering about the timing of a long-awaited hike in short-term interest rates. Kiplinger expects the central bank to raise the federal funds rate—the rate that banks charge each other for overnight loans—by a quarter of a percentage point in September at the earliest. The rate is currently near zero. Look for the yield on the benchmark 10-year Treasury, which is set by investors in the bond market, to end the year at 2.4%, up from 2.1% today.

As long as rates stay low, yield-seeking investors will have to hunt for income. With nearly half of S&P 500 companies sporting yields greater than that of the 10-year Treasury, investing in dividend-paying stocks is a no-brainer. You’ll find dependable dividend growers in Kiplinger 25 member VANGUARD DIVIDEND GROWTH (SYMBOL VDIGX), which has a defensive tilt that stands up well to volatile markets. (For more ideas, see “9 Funds for a Rainy Day,” on page 53.)

For stock investors looking ahead to the Fed’s first rate hike since 2006, timing is less important than whether the central bank moves gradually and with a lot of warning. If that’s the case (and that is what most economists expect), investors will have plenty of time before the market peaks, says Burt White, chief investment officer at LPL Financial, a brokerage firm. “We’re in the second half of the bull market, but people think we’re closer to the end than we are,” says White. Looking at the past nine initial Fed rate hikes, he notes that, on average, bull markets generate nearly 40% of their gains after the first increase.

It goes without saying that this market is anything but average, considering the unprecedented expansion of the supply of money around the globe. Will investors one day pay for super-easy policies that have kept interest rates near zero and flooded the world with money, courtesy of massive bond purchases by central banks in the U.S., Europe and Japan? “Our long-term view is that the extraordinary amount of global monetary stimulus has led to an asset bubble in both stocks and bonds,” says Tony Roth, chief investment officer of Wilmington Trust.

“We’re living off one stimulus announcement to the next. There could be a huge correction at some point when there’s no more juice in this lemon to squeeze.”

Even Fed chairman Janet Yellen has expressed concern about stock prices, which she recently deemed “quite high.” But by many measures, the market has room to run. True, stocks in the S&P 500 are trading at 18 times estimated earnings for the coming four quarters, well below average, says BofA. Since its pre-recession peak, the economy has grown by less than 9%; with one exception, peak-to-peak growth going back to 1957 has
ranged from 11% to 50%. Nor have the number of mergers, acquisitions and initial public offerings reached their past highs. And perhaps most important, “compared with other alternatives, stocks still look attractive,” says Edward Jones strategist Kate Warne. But you need to be choosy. This year, investors have flocked to small-company stocks, because they are more likely than big firms to derive most of their sales domestically, and that makes them less susceptible to the risks of a strong dollar. But large-cap stocks have advantages in a market in which economic growth is uncertain and global concerns are elevated—such as the continuing worries about whether Greece will default on its debt and leave the euro zone. Blue chips are easily traded, their earnings prospects are easier to predict, and they usually offer the cushion of a dividend yield.

### Red Flags

#### Three Ways to Protect Your Stock Gains

**1. Trim your stock holdings.** The simplest tack is to cut the percentage of your portfolio that’s devoted to stocks. We’re not suggesting that you sell everything in anticipation of a bear market. That’s market timing, and few people can do it consistently well enough to make it worthwhile. But if, say, you have 80% of your portfolio in stocks, you may want to consider trimming the allocation to 70% or 60%. Let your time horizon and tolerance for risk and potential losses dictate the amount of the reduction.

Don’t forget that selling can have tax consequences. One simple rule of thumb: Realize capital gains in tax-deferred accounts, and take losses in taxable accounts. You may want to consult your tax adviser before acting.

**2. Diversify your stocks widely.** Because U.S. stocks have left nearly all other investments in the dust over the past few years, they may have come to dominate your portfolio. So make sure you have adequate exposure to foreign stocks, which as a group are cheaper than U.S. stocks and have perked up this year. “Everybody wants to own the S&P 500,” says San Francisco money manager Steve Jana- chowski. “But the U.S. market is arguably the most overvalued market in the world. If you don’t diversify, you’re taking a big risk.”

Although markets are more closely linked than they once were, the case for diversification remains strong. Most of the time, different kinds of stocks—including growth stocks, small-company stocks, foreign stocks, real estate investment trusts and other big dividend payers—perform differently enough to justify holding a little bit of all of them. That way, your holdings won’t retreat at the same rate and the same time when a bear market strikes. True, if we have a repeat of the financial crisis, during which almost every stock category imploded, diversification won’t help much. But chances are good that the 2007–09 bear market was a once-in-a-generation or maybe even once-in-a-lifetime event.

**3. Hedge your bets.** If you’re nervous about stocks, but tax or legal issues (such as having assets tied up in a divorce) make it impractical to sell, buying a “put” option on a market index is a reasonable strategy. A put gives you the right, but not the obligation, to sell an investment at a fixed price by a certain date. You pay a price for that protection akin to an insurance premium, and if the market doesn’t fall, you can lose all the money you invested in the put.

A way to hedge without having to worry about a time limitation is to buy an exchange-traded fund that performs inversely with the stock market. For example, ProShares Short S&P 500 (symbol SH) seeks to move in the opposite direction of the S&P 500. Although the ETF has performed miserably during the bull market, it shined in 2008, soaring 38.9%, while the S&P 500 plummeted 37.0%.

KATHY KRISTOF
Consider holding more foreign stocks—particularly those in developed markets—than you’d normally own. “We still have an overwhelming bias toward the U.S., but we’re at the highest weighting for Europe and Japan in seven years,” says U.S. Trust’s Hzyz. Economies in Europe and Japan are benefiting from extensive monetary stimulus from their respective central banks, lower oil prices (both are big importers) and lower currency values relative to the dollar, which boosts exports.

A broad-based international fund is a good way to branch out overseas. ARTISAN INTERNATIONAL (ARTIX), a member of the Kiplinger 25, had 44% of its assets in Europe’s developed economies at last report and 12% in Japan. Manager Mark Yockey says European companies, exemplified by NESTLÉ (NSRGY, $78), the Swiss food giant, know how to build brands. Nestlé owns more than 20 brands that each generate at least $1 billion in annual sales, Yockey says. In Japan, he likes TOYOTA MOTOR (TM, $140). (Both stocks trade in the U.S. as American depositary receipts.)

Any further rise in the dollar is likely to be modest and gradual. If you don’t want to worry about a rising dollar eroding investment profits, consider FMI INTERNATIONAL (FMIJX), another Kip 25 fund. This fund, which hedges against currency swings, has 28% of its assets in developed Europe and 10% in Japan. Or try DEUTSCHE X-TRACKERS MSCI EAFE HEDGED EQUITY (DBEF), an exchange-traded fund broadly diversified across developed foreign markets (see “ETF Spotlight,” Feb.).

In the U.S., focus on defensive sectors, such as health care, and those that could prosper as the economy rebounds in the second half of 2015. VANGUARD HEALTH CARE (VGHCX) has delivered impressive returns at low cost and with a relatively smooth ride considering its focus on a single sector. Technology companies such as INTEL (INTC, $53) and MICROSOFT (MSFT, $49) should get a boost from a stronger labor market, as companies upgrade their systems to accommodate new employees. Retailers, restaurants and other firms that offer nonessential consumer goods or services will benefit from a long-awaited loosening of purse strings. DICK’S SPORTING GOODS (DKS, $55) sells an attractive mix of high-performance gear and sports apparel. Cash in on housing gains with SPDR S&P HOMEBUILDERS ETF (XHB), which provides exposure not only to builders but also to makers of appliances and building products, as well as home-furnishing and home-improvement retailers.

### Four Measures

**IS THE STOCK MARKET REALLY OVERVALUED?**

Only on the basis of the Shiller price-earnings ratio, which is based on average inflation-adjusted earnings over the previous 10 years, does the U.S. market look wildly overvalued.

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<th>Metric</th>
<th>Valuation</th>
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<tr>
<td>Price to estimated earnings</td>
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<td>Price to book value</td>
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As of May 1. *Data from 1960 on. †Data from 1986 on. ‡Data from 1881 on. SOURCES: Bank of America Merrill Lynch, Standard & Poor’s Dow Jones Indices, Thomson Reuters, Yahoo.

### Good Values

**Five Timely Stock Picks**

- **Affiliated Managers Group (symbol AMG, $226).** AMG delivers consistent earnings growth by acquiring majority stakes in investment managers that advise mutual funds, institutions and wealthy individuals. Through its affiliates, including Yacktman Asset Management and Tweedy, Browne Co., AMG has nearly $640 billion under management. Analysts on average see profits surging 20% this year and 14% in 2016.

- **Google (GOOGL, $551).** Shares of the dominant Internet search company have been sluggish the past year, partially because of antitrust hurdles in Europe and concerns about moderating growth. But a new chief financial officer is expected to plump profit margins and return the company to a 15%-per-year earnings-growth trajectory. Google may be “the most undervalued name in the stock market today,” says Matt Berler, of Osterweis Capital Management.

- **McDonald’s (MCD, $98).** Hurt by strong competition, changing consumer tastes and, more recently, a strong dollar, McDonald’s earnings have been under pressure the past few years, and the stock is 4% below where it traded in early 2012. But hamburgers haven’t gone out of style, says Joseph Zock, of Tocqueville Asset Management, and McDonald’s remains a dominant player run by a new CEO with a comeback plan. Plus, the stock yields 3.5%.

- **TRI Pointe Homes (TPH, $14).** TRI Pointe is the minnow that swallowed the whale. Backed by Starwood Capital, TRI Pointe went public in 2013 and merged last year with the homebuilding unit of forest products giant Weyerhaeuser. TRI Pointe, which operates in eight states, should benefit from a stronger housing market. Analysts see earnings doubling this year.

- **VF Corp. (VFC, $72).** The apparel giant has grown by acquiring leading apparel and footwear brands, including The North Face and Timberland. VP’s functional lifestyle clothing appeals to trail hikers and urban walkers alike, says Mark Dawson, chief investment officer of Rainier Investment Management. International expansion and highly profitable Internet sales are growth areas. VF has raised its dividend at an annual rate of 17% over the past decade.