MARKETS

Winners of 2013: Boring Investors

Buying and Holding U.S. Stocks Paid Off Big This Year

By TOMI KILGORE and TOM LAURICELLA

Dec. 30, 2013 8:17 p.m. ET

In the best year for U.S. stocks since 1995, the smart way to play the markets has been to follow the dumb money.

So-called dumb-money strategies, which involve buying and holding a plain-vanilla portfolio of U.S. stocks, did much better than the more complex approaches employed by hedge funds and other professional investors.

Fueled by easy money from the Federal Reserve and signs of improvement in the economy, the Dow Jones Industrial Average goes into the final day of 2013 with a gain of 29% once dividends are included, while the S&P 500 index has climbed 32% with dividends. Those gains far outpace the rally predicted by even the most bullish Wall Street strategists.

Related

Year in Review: Developed Economies Retake Growth-Engine Role

Unusual Emerging-Market Bond Bet Pays Off

All 10 Stock Sectors Post Gains in Big Year

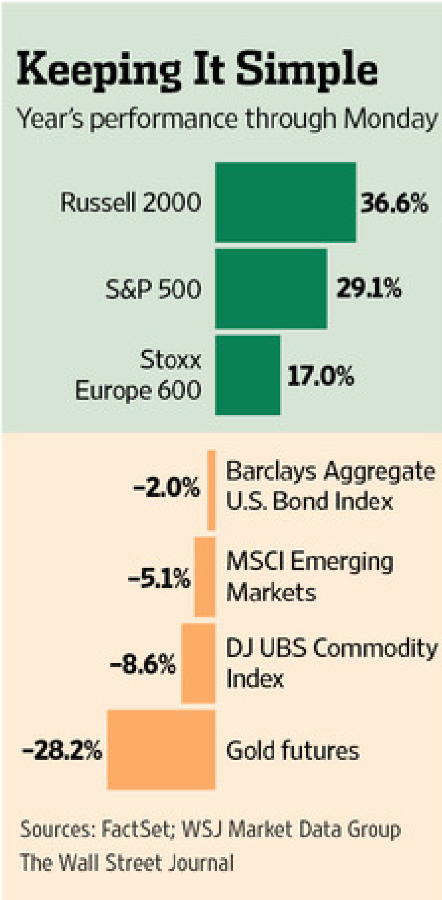
Many hedge funds were left in the dust, alongside investors who use "tactical" timing of the markets' ups and downs and those who spread their bets among a wide variety of assets such as commodities, emerging markets and exchanged-traded funds.

"The more colorful your pie chart, the worse you did," said Lawrence Glazer, managing partner at Boston's Mayflower Advisors, which oversees $1.5 billion.

It isn't always this way with big stock-market rallies. A more typical year was 2003 when the Dow rose 28% including dividends. That year, the MSCI Emerging Markets index soared 56%, the broad-based Barclays U.S. Aggregate Bond Index gained 4.1% and the DJ UBS Commodity Index climbed 23%.

As a result of stocks' singular rise in 2013, some advisers are dealing with a brand-new problem: After years of struggling to convince investors to put more money in U.S. stocks, they now are trying to persuade clients it is time to put some of it into underperforming investments, especially bonds.

That is no easy task. Investors have been deluged with warnings that the multi-decade bull market for U.S. bonds is over, as interest rates look poised to rise, and that yields are too low to compensate for the risk of losing money. The Barclays U.S. Aggregate Bond Index is down 2% for the year through Friday, its first annual decline since 1999.



Getty Images

"A lot of people got really scared [of bonds], because this is the first time they've seen fixed income, which is supposed to be their safety bucket, take a hit," said Daniele Donahoe, chief investment officer at Charlotte, N.C.-based Rinehart Wealth Management, which manages $300 million. "Nobody wants to own anything that's not doing well."

In the horse race among global markets in 2013, U.S. stocks trailed only the explosive and often-volatile rally in Japan's Nikkei Stock Average. The Nikkei has soared 57% due to aggressive monetary easing by the Bank of Japan.

But for U.S. investors, staying glued to old-fashioned—and often low-fee—U.S. stock funds generally turned out to be the right call, advisers say. The average mutual fund focusing on large-company stocks is up 32% this year, according to Morningstar Inc. Small-company stock funds have returned 38% on average.

And despite worries about the outlook for Federal Reserve policy, turmoil in the Middle East and a federal government shutdown, U.S. stocks suffered only small and short-lived pullbacks. There were just five selloffs of 2% or more for the S&P 500 this year, the worst being a 5.8% decline from May 21 through June 24 amid fears the Fed soon would start reducing stimulus.

"All of the sales we made this year have been mistakes," said David Rolfe, chief investment officer of St. Louis's Wedgewood Partners, which has $7 billion of assets under management. "If you could've just invested in one of the major indexes, and worked on your golf game the rest of the year, you would've hit a home run."

European stocks rose, but underperformed the U.S. by a wide margin, with the Stoxx Europe 600 rising 17%. And emerging-markets stocks, which often perform best during global economic expansions, declined, with the MSCI Emerging Markets index down 5.1% through Monday. China's benchmark Shanghai Composite is down 7.6%.

"People like it when diversification adds to value, but they see diversification has detracted value this year," said Edward Painvin, chief investment officer at money-management firm Chase Investment Council in Charlottesville, Va., which oversees $600 million of assets.

Investors tend to use gold as a hedge against inflation and rising interest rates, and gold futures tumbled 28%, the first annual decline since 2000.

Other commodities, usually beneficiaries of global economic growth, also suffered. The DJ UBS Commodity Index dropped 8.6%.

Investors who eschewed the simplicity of buying U.S. stocks and sought more exotic products also were punished.

Hedge funds, for example, which for big fees typically run portfolios including bets that stocks will fall, lagged far behind the broader market because of those bearish wagers.

The HFRI Equity Hedge Index was up 13% through the end of November, and appears on track to finish 2013 with a gain just shy of 14%, says Ken Heinz, president of Hedge Fund Research Inc.

Other strategies marketed as a way to own stocks but avoid big price swings also lagged. That was the case for portfolios that promise low volatility because they hold defensive stocks, such as utilities and consumer staples. The $3.9 billion PowerShares S&P 500 Low Volatility Portfolio exchange-traded fund is up 20% for 2013.

But for many advisers and investors, 2013 left portfolios out of line with their target mix of investments. For a portfolio that started the year with 60% of its value in U.S. stocks and 40% in bonds, the 32% year-to-date return in the S&P 500, coupled with the decline in bonds, would leave the split today at 67% in stocks and 33% in bonds.

Rebalancing a portfolio often means going against a trend, which advisers say is an even tougher sell this year than usual.

Chad Carlson, wealth manager at Illinois-based Balasa Dinverno Foltz, with about $2.6 billion under management, said one client of working age was adamant about not rebalancing his stockholdings position.

"Why the heck would I want to do that, when the market is up 29%?" Mr. Carlson recalls the client telling him in the past month.

After an hour-long, in-person meeting, the client consented. "I'm paying you guys to do this stuff, and I don't necessarily agree, but go with it. If you're wrong, I'm going to jump on you," Mr. Carlson said he was told.

Write to Tomi Kilgore at tomi.kilgore@wsj.com and Tom Lauricella at tom.lauricella@wsj.com