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'Macro' Forces in Market Confound Stock Pickers

By **TOM LAURICELLA** And **GREGORY ZUCKERMAN**

The market turmoil has battered many investors over the past few years. But for stock pickers like Neuberger Berman LLC's David Pedowitz, it has made their entire investing approach feel like an exercise in futility.



Mr. Pedowitz buys and sells stocks based on research and analysis of individual companies. His investment strategy, he says, has been upended by a tidal wave of "macro" forces—big-picture market movers like the economy, politics and regulation.

Lately, stocks have been moving up and down each day largely at the mercy of forces beyond a company's control. And that's wreaking havoc for traditional stock pickers. WSJ's Jason Bellini reports on the macro factors that are dominating the market.

More and more investors aren't bothering to pore through corporate reports searching for gems and duds, but are trading big buckets of stocks, bonds and commodities based mainly on macro concerns. As a result, all kinds of stocks—good as well as bad—are moving more in lock step.

"It's unbelievably frustrating," says Mr. Pedowitz, who helps manage \$4.5 billion for wealthy clients and has 25 years of investing experience. "It's enough to make you crazy."

That kind of talk has become widespread on Wall Street as stock pickers discover that long-held investment strategies are no longer working very well.

Some data suggest that stock pickers are having a harder time outperforming the market. Each year between 1995 and 2007, for example, on average, 50% of mutual funds focusing on large, fast-growth companies beat the Russell 1000 Growth Index, a benchmark for that category, according to Morningstar Inc. Over the past year, only about 24% of those funds beat that index.

The stock portfolio Mr. Pedowitz helps run at Neuberger Berman has managed to stay ahead of the Standard & Poor's 500-stock index so far this year, he says, but its value has been whipped back and forth far more than usual.

Stock pickers say macro forces began moving stocks in a big way during the 2008 financial crisis, and that has continued this year following the European debt crisis. Traders also are focusing on the potential for a double-dip recession to hit corporate profits; on government deficits; and especially on what central banks will do about stimulus programs that pumped cash into the economy.

A host of other factors is contributing to the macro trend. The rise of exchange-traded funds, which typically track broad market indexes or benchmarks, has made it easier for investors to make broad bets on commodities, bonds and currencies. Such funds now account for 30% of daily stock-trading volume. Individual investors and pension funds have been pulling money out of stocks, leaving shares more vulnerable to trading by hedge funds with short time horizons.

Whether such forces will alter the stock-investing landscape permanently is anyone's guess.

"Stock picking is a dead art form," contends James Bianco of Bianco Research. "Macro themes dominate the market now more than ever."

Some stock pickers say the current macro focus is only temporary, and will generate great investment opportunities simply because companies with different outlooks shouldn't be moving in lock step long-term. Eventually, they say, stocks will move in line with their fundamental values.

"When you have securities that are all moving in the same direction, that by its nature opens up opportunities," says Cindy Sweeting, one of the managers on the \$17.3 billion Templeton Growth Fund.

In recent months, stocks have been moving in lock step to an almost unheard of degree. A widely followed statistic called correlation measures the tendency of investments to move together in a consistent way. Between 2000 and 2006, on average, the correlation of stocks in the S&P 500 was 27%, according to Barclays Capital. That meant that most stocks were moving independently of the index, driven more by company fundamentals, says Barclays stock-market strategist Barry Knapp.

In the run-up to the Iraq war in 2003, correlations approached 60%, suggesting that the looming war was driving stock prices, says Mr. Knapp.

Between October 2008 and February 2009, at the height of the financial crisis, correlation hit 80%, meaning lots of stocks were moving in lock step. When stocks rallied last year, the figure fell to 40%, then it spiked back over 80% during the European debt crisis, according to Barclays. What has caught many investors off guard is that correlation stayed high over the summer. In mid-August, correlation was 74%. In recent weeks, it has drifted down to 66%.

Prior to the financial crisis, such high correlation levels were seen previously only during the Great Depression, according to data compiled by market-strategy firm Empirical Research Partners.

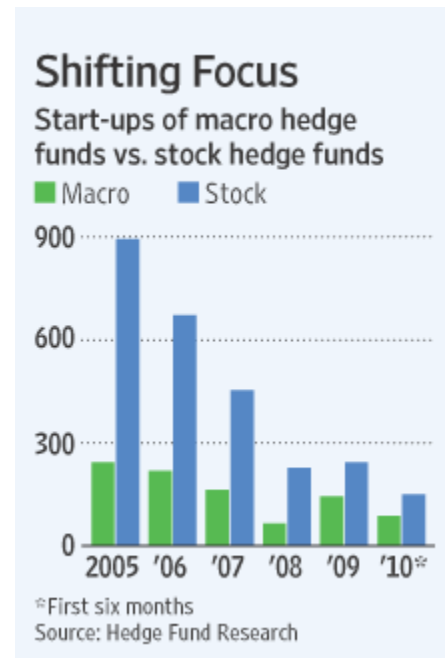
"We had hoped 2010 would be back to stock picking," says Robert Doll, chief equity strategist at money manager BlackRock Inc.

Templeton's Ms. Sweeting says high correlations have made it especially difficult for funds to distinguish themselves through stock picking. Over the years, the Templeton Growth Fund often has posted returns much different from the overall market. During the bear market of 2001, for example, the fund gained 0.5%. But in 2009, its 30.8% gain was almost exactly the same as the MSCI World Index, against which the fund is measured.

"All stocks are moving in the same direction," says Ms. Sweeting. "I've spent three decades in this market, and it's the most macro-obsessed I've seen in a long time."

Among stock funds focusing on large, undervalued stocks, about 18 percentage points separated the best and worst performers between 1995 and 2007, according to Morningstar. (To eliminate outliers, the data excludes the top and bottom 5%.) Over the past year, the gap between the top and bottom performers has narrowed to 10.5 percentage points.

Stock pickers say the market's macro focus has meant that company earnings no longer drive stock prices as they once did. Over the past year, stocks that topped quarterly earnings expectations outperformed the market by just 0.3 percentage point during the week after the earnings were reported, according to Birinyi Associates, a research and money-management firm. By contrast, from May 2002 through August 2009, stocks beat the market by 1.5 percentage points following earnings reports that beat expectations.



Another frustration for stock pickers is the tendency of investors to pile in and out of stocks based on macro considerations of overall market risk.

On a "risk on" day, the mood of investors is confident and they flood into stocks and other investments perceived as risky, such as junk bonds, emerging markets and commodities. But when it's "risk off," money comes sloshing out of those investments and into so-called safe-haven investments such as U.S. Treasuries, the U.S. dollar or Japanese yen. Shortly before the May 6 "flash crash," for example, a macro concern—the yen's sudden rise against the euro—triggered a wave of stock selling.

Some stock pickers are trying to adjust by folding more macro analysis into their thinking.

"For years I had believed that I didn't need to take a view on the market or the economy because I considered myself a 'bottom-up investor,'" said hedge-fund manager David

Einhorn of Greenlight Capital last year. "The lesson that I have learned is that it isn't reasonable to be agnostic about the big picture."



David Einhorn *Associated Press*

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Mr. Einhorn, known for his high-profile bet against Lehman Brothers right before it collapsed, has placed a big macro bet that gold prices will rise because of concerns about the U.S. budget deficit and its damaging effect on the U.S. dollar.

In April, veteran hedge-fund manager Lou Gerken became so downbeat about stock picking that he decided to shut down his two stock funds, which held about \$80 million in client money and were down about 10% for the year. He says he now is focusing on a global bond fund and spends his days reading macro-oriented publications and research from gloomy economist Nouriel Roubini. Many of his clients shifted their money to the bond fund, he says.

Referring to legendary stock pickers Benjamin Graham and David Dodd, he says: "I'm a Graham and Dodd value investor, and geopolitical issues didn't matter 10 years ago. But they sure matter now."

As investors grow frustrated with stock picking, they're flocking to mutual funds that specialize in macro investing. This year, through August, investors have pulled \$42 billion out of U.S. stock funds and have plowed \$13.3 billion into three macro-oriented funds alone: BlackRock Global Allocation Fund, Eaton Vance Global Macro Absolute Return Fund and the Ivy Asset Strategy Fund.

Goldman Sachs Asset Management, Dreyfus Corp., Pioneer Investments and the Hartford Mutual Funds are among those that have launched macro-driven mutual funds this year.

Hedge funds are moving in the same direction. Last year, 184 new macro hedge funds were launched, compared with 203 funds started by traditional stock investors. By contrast, in 2005 there were 894 new stock funds and 244 new macro funds.

Hedge funds are also doing more trading of government bonds, which are tied to central-bank moves and inflation predictions. In 2009, hedge funds generated about 3% of trading volume in U.S. government bonds. This year, that share jumped to roughly 20%, according to consulting firm Greenwich Associates.

Macro strategies, however, are no magic bullet for making money in today's markets. Last year, macro funds rose 4.3%, compared with a gain of nearly 20% for the average hedge fund and 26.5% for the S&P 500, including reinvested dividends, according to Hedge Fund Research. Macro hedge funds are up 1% this year through August, trailing the 1.7% gain on the average hedge fund but better than the 0.4% loss in the S&P 500.

Last month hedge-fund manager Stanley Druckenmiller, best known for engineering George Soros's profitable \$1 billion bet against the British pound in 1992, shut down his fund after losing money this year.

Dylan Grice, a strategist at Société Générale, says, "Most of us are rubbish at seeing macro events coming, let alone timing them."

Most stock pickers have portfolios with dozens or hundreds of investments, so getting a few calls wrong generally doesn't make a big dent in returns. But macro funds tend to have a lot riding on a handful of bets.

John Burbank, founder of Passport Capital LLC, a San Francisco-based macro-hedge-fund manager, thinks the macro-driven environment will persist for some time. The reason, he says, is the difficulty of solving some of the issues that have led to the macro-dominated markets, such as the U.S. budget deficit and economic overcapacity that has resulted in persistent high unemployment rates.

Mr. Burbank says he is building a network of sources in Washington in an effort to get a better read on political and regulatory issues. He compares investing in the U.S. to investing in emerging markets, where he started his career.

"What is happening with the country, with the government, and what are their policies? These are the questions as an emerging-market investor that you ask before you do any bottom-up work on stocks," he says.

Many stock pickers, bound by rules that require their funds to keep investing in stocks, can only tweak their strategies and hope that the current environment doesn't last much longer.

At Neuberger Berman, Mr. Pedowitz says a little uncertainty is good for stock pickers, but there can be too much of a good thing.

"In normal levels of uncertainty, we're wallowing in it like happy pigs, because you need that uncertainty to find bargains," he says. However, for now there's so much uncertainty, he says, "it's overwhelming."

Tough Times for Stock Pickers

As individual stocks increasingly move in lock step with the broader market, stock-picking funds have had a tougher time beating benchmark indexes.

Correlation of stocks in the S&P 500 index to movement of the whole index. The higher the percentage, the more stocks are moving in lock step.



Sources: Barclays Capital; Morningstar

Percentage of mutual funds beating their benchmark indexes, by fund type

