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Core Conundrum for Investors: Bonds or Stocks?

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As the sovereign debt debacle in **Europe** slogs along, and with the global **economic recovery** seemingly stalled out, **investors** and analysts are sizing up a drastically reshaped global landscape.

In this increasingly volatile market, some see **stocks** as having much better prospects than **bonds**, assuming Europe rights itself and the economic recovery finally takes off. Others believe the three-decade bull market for bonds still has legs.

A lot may depend on your inflation outlook — but bonds, particularly Treasurys, have performed so well for so long, it's hard to think fixed income is the horse to ride. At the same time, stocks have been full of disappointment lately, and investors are much more risk-conscious today.

Still, the sky hasn't fallen — at least not yet. Consequently, is a bull market in stocks hiding around the bend?

Sam Stovall, chief equity strategist, S&P Capital IQ, accepts the premise that stocks look attractively valued for the long term, but he's generally cautious, citing many problems, particularly in Europe. Currently, he says, investors would rather play it safe and stick with a more conservative portfolio and investment outlook.

Long-Term vs. Short-Term

"Investors who have U.S. Treasurys are not convinced that now is the time to sell, as their primary goal is the return of their money rather than the return on their money," he says. "They're not looking for capital appreciation or income; they just want their money to be safe."

That perceived safety of bonds could prove illusory at these levels, according to Larry Luxenberg, a financial adviser with Lexington Avenue Capital Management in New City, N.Y.

"While these short-term fluctuations in stocks can be unnerving, the long-term potential of stocks remains attractive," says Luxenberg. "Investors have gotten conditioned to be too pessimistic about stocks, and they need to consider the possibility that there could be a brighter future for equities."

Indeed, investors today remain confused because although stocks look attractively valued for the long term, their emotions are whipsawed by almost daily fluctuations in the global equity markets and constant reminders that another **Lehman-like catastrophe** could be brewing in Europe. At the same time, they are being advised by bond experts that Treasury bonds are likely the next bubble.

"Investors also have to realize that when it comes to 'news,' if it bleeds, it leads, meaning bloody stories sell," adds Stovall.

The bond market has consistently trumped returns from stocks over the past decade.

From Dec. 31, 1999, through May 29, 2012, the Barclays Capital U.S. Aggregate bond index — which covers the investment-grade bond market, including government and corporate bonds as well as mortgage- and other asset-backed securities — returned 104.1 percent to investors. By comparison, the total return of the **S&P 500** was 14.2 percent, including share price gains and dividends.

No wonder, then, that many investors today prefer the merry-go-round to the market roller-coaster.

If the world economy worsens, corporate profits could as well.

Investors are not heartened by stock market valuations that are trading at a discount to long-term average price-to-earnings ratios, according to Stovall.

For instance, the S&P 500 index is trading at 13.2 times trailing 12-month operating **earnings**. That's a 26 percent discount to the median P/E of the last 25 years.

Role Reversal Time

Some market watchers say enough is enough, though.

"Investor behavior is paradoxical. It's mathematically impossible for bonds to keep appreciating anything like they have over the past several years," says financial planner Jonathan M. Bergman, citing financial guru Jeremy Siegel, author of "Stocks for the Long Run."

"With rates at record lows, there's no place for long-term bond prices to go but down," says Bergman, vice president of Scarsdale, N.Y.-based Palisades Hudson Financial Group.

"Stocks are very cheap," adds Charles Rotblut, editor of the AAII (American Association of Individual Investors) Journal. "But we are facing a situation where things could go right or they could go wrong. So, while stocks look very attractive over the long-term, there are issues that could hurt their short-term returns."

Of course, for some money managers, the question should not be framed as either/or.

"We see increased risk in both stocks and bonds compared to a few years prior," says Jaime Desmond, COO, Ladenburg Thalmann Asset Management in New York. "Instead of predicting which has a brighter future, we prefer to diversify our risk away from both asset classes through inclusion of **alternative investments**."

At the same time he warns investors to be judicious because except for Treasury bonds, most other fixed-income assets have been moving in tandem with the equity markets, diminishing their diversification benefits.

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