Investor Insights & Outlook

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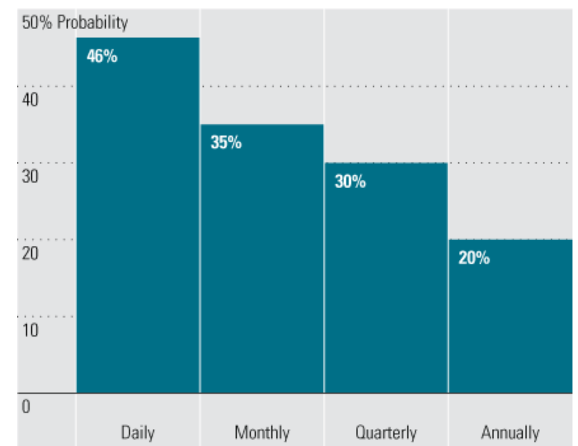
Short-Term Focus: Coping with Near-Term Fluctuations

Instant access to real-time quotes and media reports can make it difficult for investors with a long-term investment horizon to stay focused on their goals. In reality, these daily market movements may not be as extreme as they seem. As investors look longer term, their perception often changes. Short-term market fluctuations can be quite volatile, and the probability of realizing a loss within any given day is high. However, the likelihood of realizing a loss has historically decreased over longer holding periods. The image illustrates that while the probability of losing money on a daily basis over the past 20 years was 46%, the probability dropped dramatically when analyzing an annual time period—20%. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Probability of losing money in the market
1991–2010



Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. Probability of loss is calculated as the number of negative periods divided by the number of total periods using the specified frequency of data.

Advisor Corner

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Monthly Market Commentary

2011 ended with the S&P 500 almost flat after a tumultuous year. As Europe continued to be of concern, markets loved the coordinated central bank maneuver that ensured liquidity across global financial systems in order to calm panicky investors. Although a global economic slowdown is very real, given the possibility of a European financial contagion and a slowdown in China, the U.S. could potentially be the engine of worldwide growth in 2012.

Employment: December saw the addition of 212,000 private-sector jobs, mostly from large increases in delivery personnel, retail sales workers, and construction workers. The holiday season and the boom in online shopping activity accounted for the two former, while unusually warm weather in December helped the latter. While sizable, the private sector has lost 8.8 million jobs throughout the recession and has only gained back 2.8 million of these jobs. At current growth rates, three additional years are still required to recoup all these jobs. The government sector, on the other hand, continued to shed jobs (another 12,000 jobs in December). This brings the total number of government jobs lost since the recovery to almost half a million. The unemployment rate fell to 8.5% in December, aided mainly by increased employment with some help from labor force dropouts.

Manufacturing: Both government new-order reports and industrial-production reports indicated that the U.S. industrials sector was not declining, with some reports even showing signs of modest growth. Positive new-order reports are particularly important—they help predict production and employment in the upcoming months. The most-recent durable-goods order report reflected strong numbers for autos and airplanes, while others, such as non-defense capital goods, slowed. Higher inventory levels and better pricing for autos and Boeing's anticipated production jump to satisfy deliveries for its 787 Dreamliner contributed to these numbers.

Consumer: This holiday season was a great time to be a consumer, as opposed to a retailer. As consumers continued to spend and take advantage of phenomenal deals and discounts, some retailers saw their margins decline as a result. Luxury and low-end retailers did relatively well, but companies serving the middle market, such as Best Buy and Target, struggled. Apparel companies were hit especially hard, given the unusually warm weather in December.

Housing: Stringent lending standards and general attitudes toward home ownership continued to hold back the housing market despite housing affordability remaining at a record high with low prices and low mortgage rates (now below 4%). This could be seen in the 7.3% jump of pending home sales (homes that go under contract but have yet to close, pending appraisals and financing) in November compared with October, which are now at their highest levels in 19 months. However, the housing market continues to underperform, and home prices are still more than 30% below previous highs over the last decade. A catalyst, such as a stronger employment market, may be required before the housing market starts to improve significantly.

Year-end Insights: 2011 saw the U.S. economy grow, but at a much slower rate than predicted by many economists. Poor weather, oil and gas price shocks caused by political unrest in the Middle East, and supply-chain disruptions related to the Japanese tsunami all contributed to the first half's abysmal growth rates. Growth accelerated, as oil and gas prices fell back down and production facilities came back online in the second half of the year. 2011 also brought to light the severity of the European sovereign debt crisis and the slowdown of China's economy, causing investors and companies alike to sit on the sideline, weary of another global recession. Morningstar economists believe that the U.S. economy has more potential for upside than downside in 2012 as consumers continue to spend, manufacturing picks up, U.S. oil production increases, and the housing market becomes stronger.

Are Bonds Adding to Your Equity Exposure?

These are trying times for yield-seekers. The Federal Reserve has kept interest rates ultralow for more than two years, and Federal Reserve chairman Ben Bernanke gave no indication in his recent press conference that the Fed will depart from that stance anytime soon. That may be good news for those in the market for home loans, but it's surely unwelcome for seniors and others trying to wring a livable income stream from their portfolios. Yields on cash instruments such as certificates of deposit are barely in the black, while you're lucky to pick up a yield of more than 3% on an intermediate-term bond fund.

Given this backdrop, it probably shouldn't be surprising that some investors appear to be chasing yields. Among bond funds, some of the biggest beneficiaries of new assets during the past year have been those that offer higher yields than high-quality bonds in exchange for some extra risk.

Of course, it's highly possible that investors are making the not unreasonable bet that the economy will continue to improve, thereby boosting these credit-sensitive sectors of the bond market. (Issuers are less likely to default on their bonds in a strengthening economic environment.) But it's also likely that some investors are focusing on the potential for higher yields without paying due attention to the downside.

All market shocks are different, of course, but they're often characterized by a flight to quality that puts pressure on credit-sensitive securities such as high-yield bonds and bank loans. During the period from mid-2007 through December 2008, for example, both high-yield bond funds and bank-loan funds performed poorly. This precipitated an unprecedented buying opportunity in credit-sensitive bonds, but following a more than two-year run-up in such securities, valuations aren't what they once were.

In addition to considering the risks, investors who are venturing into credit-sensitive bonds at this juncture should also be aware of what they might not be getting: diversification, particularly if they're looking to bonds as an antidote to an equity-heavy portfolio. It's true that credit-sensitive sectors like high yield and bank loans can be considered a good diversifier for portfolios that are skewed toward high-quality fixed-income securities such as government bonds, mortgage-backed securities, and high-quality corporate debt.

The high-yield sector's performance correlation with the equity market has been strong during the past decade (this means that, whether rising or falling, they tend to move together). The correlation of bank-loan funds with stocks has also been relatively strong (although less so than that of high-yield bond funds). Both asset classes have been more highly correlated with stocks than with bonds.

Does that mean you should reflexively avoid high-yield and bank-loan funds? Not necessarily. These bonds do provide some diversification benefit to high-quality bonds. And while high-yield bonds wouldn't be impervious in a period of rising interest rates, their extra yield cushions would most certainly hold them in better stead than gilt-edged Treasuries in such an environment. And bank-loan funds offer built-in protection against rising interest rates. If the economy continues to strengthen, high yield and bank loans would likely continue to chug along. But it's also a mistake to assume that a bond is a bond is a bond. If you're looking at mutual funds that delve into credit-sensitive sectors, it's crucial to thoroughly understand a prospective holding's strategy and downside potential before adding it to your portfolio.

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not ensure a profit or protect against a loss in a declining market.

Tax-friendly States for Retirees

Federal taxes are the same wherever you choose to retire; however, state and local taxes add up depending on the state you pick to spend your retirement years. Taxes may apply to your retirement/pension income, purchases, real estate and social security benefits.

Taxes on individual and pension income differ from state to state. Seven states in the U.S. (Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming) currently do not tax individual income. On the other hand, California, District of Columbia, Hawaii, Iowa, Maine, New Jersey, New York, Oregon, and Vermont tax retirement income at a rate of 8% or higher. Pennsylvania and Mississippi exempt pension income completely, while states like Michigan and Maine exempt only a portion of pension income. If you estimate receiving considerable income in retirement, state income taxes could play a significant role in what you get to keep.

In addition to state taxes on retirement and pension income, retirees also need to look at sales tax charged on items they purchase. Sales tax varies from state to state with some states charging sales tax as high as 7%, while others adopt a “no sales tax” policy. Alaska, Delaware, Montana, New Hampshire, and Oregon have no state sales tax, while California has the highest sales tax rate of 8.25%. Retirees who rely only on a fixed source of income in retirement should also carefully consider property taxes and estate taxes when estimating their tax liabilities.

Source: 2011 CCH Whole Ball of Tax. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment, tax, or legal advice. The information provided is as of October 2011. Please consult with your financial professional regarding such services.

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