Investor Insights & Outlook

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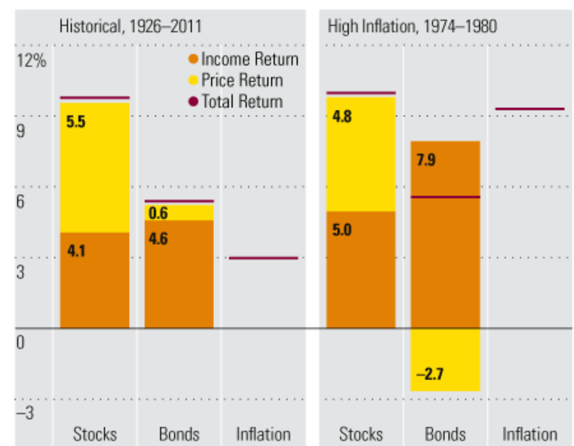
Dividends and Inflation

As an investor, you may ask if an allocation to dividend stocks in your retirement portfolio will help keep up with inflation. Examining stock returns during periods of high inflation may answer this question. Dividend-paying stocks may offer benefits such as stability through income return and inflation protection. While stock prices tend to be volatile, dividends may serve as a stable component of total return and may provide better inflation protection compared with bonds. Between 1974 and 1980 (high inflation period), the average rate of inflation was 9.3%, much higher than the historical rate of 3%. During this time, bonds yielded 7.9% from income, but prices declined by 2.7%, resulting in a total return of 5.6%—way short of inflation. On the contrary, stocks returned a total of 10%: 5.0% from dividend income and 4.8% from price return, outpacing inflation for this time period.

Performance of Stocks and Bonds Relative to Inflation



The 1974–1980 time period was chosen as representative of high inflation because it contains multiple consecutive years when inflation was 5% of higher (except 1976). The sum of the price return and income return may not equal the total return due to compounding. Past performance is no guarantee of future results. Dividends are not guaranteed. Diversification does not eliminate the risk of experiencing investment losses. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes. Stocks are represented by the Standard & Poor's 90 index from 1926 through February 1957 and the S&P 500® index thereafter, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Bonds are represented by the 5-year U.S. government bond and inflation by the Consumer Price Index.

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Monthly Market Commentary

Investors continued to monitor the situation in Europe, as news on Spanish financials moved markets both down (poor Spanish bank audits) and up (support loans for Spanish banks). Up to this point, there is still no long-term remedy for European countries, with the expectation that they will continue to struggle over the next several years under austerity programs, diminished growth prospects, and waning confidence.

While economic data in the U.S. were generally weak, they were not weak enough to drive the Federal Reserve to introduce a new program. Instead, the Fed merely extended Operation Twist until at least late 2014. Morningstar economists doubt that the program will have much more than a symbolic effect on rates, given the already-low rates on long-term securities.

Employment: June saw a disappointing 84,000 jobs being added, mostly from sluggish private sector job gains. While the economy actually added 815,000 jobs, 731,000 were subtracted because of the seasonal adjustment factor. The good news is that in July, the seasonal adjustment factor will add, instead of subtract, more than 100,000 jobs to the total number, so that's something to look forward to. The unemployment rate remained at 8.2%.

Manufacturing: Manufacturing data in June fell sharply, mainly from a massive drop in new orders. This was the largest month-to-month decline since October 2001, and reversed 37 straight months of positive growth readings. Morningstar economists believe that many firms, faced with economic uncertainty in both developed and emerging economies, may have held back on new orders. However, at this stage of the recovery, the U.S. economy can tolerate some weakness in the manufacturing sector since it only represents 11% of overall employment. Month-to-month durable goods orders jumped 1.1%, but this was not enough to offset several previous months of decline. On a year-over-year basis, growth has slowed materially, falling to 4.6% from 6.9% in the prior month.

Auto: Auto sales have been a key driver in the economic recovery, and while they exploded upward in the beginning of the year because of favorable weather conditions, growth has tapered off from March through May. Fortunately, auto sales in June jumped back up to 14 million units from 13.7 million in May, which was 21% above last year's tsunami-blighted numbers, putting a stop to the downward trend.

Housing: Housing data in June have been highly optimistic, with uniformly positive pricing data, new home constructions trending upwards, existing home sales data driven up at least partially by a lack of quality inventory, and homebuilder-related financial data continuing to rise. Morningstar economists believe that the more predictive, earlier-in-the-cycle data is stronger than the more concurrent data, indicating more gains ahead. Furthermore, low rates, falling inventories, and higher sales levels should lead to better pricing results as well.

Quarter-end insights: It has become more clear that the U.S. is less dependent on exports than many other countries (U.S. exports represented only 13% of GDP according to 2010 data), and so a general slowing of the world economy would not drastically affect the U.S. economy. However, the U.S. economy is not the same as U.S. stocks, so S&P 500 companies that have substantial overseas exposure are still at risk. Stocks with lower overseas exposure, such as utilities, communications, and health-care stocks, were among the best performers in the second quarter. The relative U.S. strength showed up in country-level data as well, with U.S. indexes down only 5% near the end of the second quarter, while both European and emerging-market indexes were down 10-15% for the quarter. Overall, consumers continued to spend, fueled partially by falling gasoline prices. Unfortunately, low commodity prices were bad news for many basic material companies, as prices for their goods dropped while costs of production remained relatively high.

Retirees: Non-Traditional Investment Risks

Volatile markets pose several challenges for retirees who rely on receiving a livable income stream from their investments. Interest rates are low and likely to stay low for the foreseeable future, making cash and high-quality bonds a safe parking place for now. Amid such a challenging environment, it's hard to blame retired investors for looking beyond traditional investments like stocks, bonds, and cash, or the mutual funds and exchange-traded funds that invest in these securities.

Many investors have flocked to gold and other precious metals, while others have gravitated toward investment types like life settlements, distressed real estate investments, and private mortgage investments. Such non-traditional investments might hold the promise of higher returns compared with traditional asset classes, but there is often a trade-off of higher risks and/or costs. Moreover, investors in non-traditional investments might not benefit from the same liquidity, transparency, and regulatory oversight that investors in traditional assets have. The following three asset types have picked up traction, but it is important to understand the risks before entrusting your hard-earned cash to them.

Life Settlements: A life settlement originates when a life insurance policyholder, often an elderly or terminally ill person, sells his or her interest in the policy to a third party, usually at a level that is well below the policy's stated death benefit. The third party then resells, often by issuing securities, that interest to investors who in turn must keep the policy in effect by paying its premiums. When the originally insured person dies, the owner of the security collects the death benefit. The rate of return on a life-settlement investment will hinge on when the originally insured person dies. If death occurs within his or her estimated life expectancy, the return will be relatively high. But if the original policy owner lives well beyond the expected time frame, a life settlement can be a poor investment. Not only will it take a while to pay off, but the investor will have to fork over premiums on a regular basis.

Distressed Real Estate: Distressed properties typically sell at prices lower than what the owners paid and may be under foreclosure; their prices may also be low in absolute terms. As with investing in any other security type, seeking low valuations is a key way to bring down your risk, but distressed real estate investing is far from a low-risk endeavor. Distressed properties may require substantial additional investment before they can be rented or resold, and there is no guarantee that a seemingly low-priced property won't fall further still. Finally, real estate can be illiquid, and for smaller investors can be cost-prohibitive to build a diversified portfolio of properties.

Private Mortgages: The troubled housing market has given rise to another real estate-related investment, the private mortgage. In contrast to a loan extended by a bank or financial institution, a private mortgage is funded by individuals, groups of individuals, or a corporation that specializes in making such loans. A private mortgage holder may be able to earn a substantially higher interest rate than he or she can earn on cash or high-quality bond investment. At the same time, the risks of a private mortgage loan are also a lot higher than cash or bonds, even though the loan is secured by the property. Individuals usually turn to the private mortgage market because they can't secure bank financing; thus, they might have poor credit or limited down payments. Those risks can be exacerbated because it can be difficult to diversify in the private mortgage market.

Retirees should exercise caution when investing in non-traditional assets. It is important to understand that investors in these non-traditional assets might have to give up transparency, liquidity, and regulatory oversight.

Annuities: Beware of Excess Withdrawals

It's extremely important to understand the impact of withdrawals on a living benefit attached to an annuity contract. The most widely used living benefit today is the lifetime guaranteed minimum withdrawal benefit (Lifetime GMWB). These usually allow you to make withdrawals from your account up to an annual limit (usually 4–6% of your investment). If you withdraw more than that percentage, future payments may be reduced. Sometimes, an excess withdrawal triggers a reset of the base on which your guaranteed amount is calculated. These withdrawals can also negatively impact the account value and death benefit. Example: You purchase an annuity for $100,000 that allows you a guaranteed 5% annual withdrawal until you start receiving your monthly payments for life. You may withdraw $5,000 every year. If you take out more than $5,000, your annual guaranteed withdrawal amount may decrease, and you won't be able to take out as much the following year. An excess withdrawal of, say, $5,500 will trigger a reset of your benefit base to equal your current account value. If the current value of your investment sub-accounts is, say, $80,000, you now get 5% of $80,000: only $4,000. The examples presented herein are for informational purposes only. They are not representative of any specific annuity and do not constitute investment advice. Annuities are suitable for long-term investing, particularly retirement savings. Withdrawal of earnings will be subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal tax penalty. Additional fees apply for living-benefit options. Investment restrictions may also apply for all living-benefit options. Violating the terms and conditions of the annuity contract may void guarantees. Read your prospectus carefully for all the fees and expenses that may apply to your variable annuity contract. It is also recommended that you consult with a financial advisor and tax advisor before purchasing an annuity.

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