Investor Insights & Outlook

Find the Right Stock/Bond Mix for College Savings

When it comes to selecting specific investments for a college portfolio, asset allocation is every bit as crucial, if not more so, than it is for retirement savers. Retirees can delay retirement or work part-time longer if their retirement portfolios come up short. Most young people, on the other hand, want to go to college right after high school, making the target date for a college fund much more specific. (The target date is the approximate date when investors plan to start withdrawing their money for college.) As it takes most students only four to five years to get through college, a college fund's drop in value during high school or early college years can be catastrophic. The principal value of such funds is not guaranteed at any time, including at the target date.

A healthy share of the assets flowing into 529 plans is now directed toward age-based options. Much like target-date mutual funds, age-based options contain a mix of stocks, bonds, and cash, and grow progressively more conservative as your child nears college age. But it's important to conduct due diligence on an age-based plan beforehand. And if your 529 plan's age-based options are dramatically out of whack with industry averages, that's a red flag to look for another 529 plan, create your own age-appropriate portfolio using individual funds, or supplement the age-based plan with individual stock, bond, or cash holdings.

Government bonds and Treasury bills are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. Diversification does not eliminate the risk of experiencing investment losses. 529 plans are tax-deferred college savings vehicles. Any unqualified distribution of earnings will be subject to ordinary income tax and subject to a 10% federal penalty tax.

Advisor Corner

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Keeping It Real

Inflation has averaged 3.1% over the last 30 years. This might not seem like much, but this reported figure only tracks total goods and services purchased by the typical consumer. This is a good measure for the economy at large, but it may not be representative for individuals whose lifestyles and buying habits differ from the typical consumer.

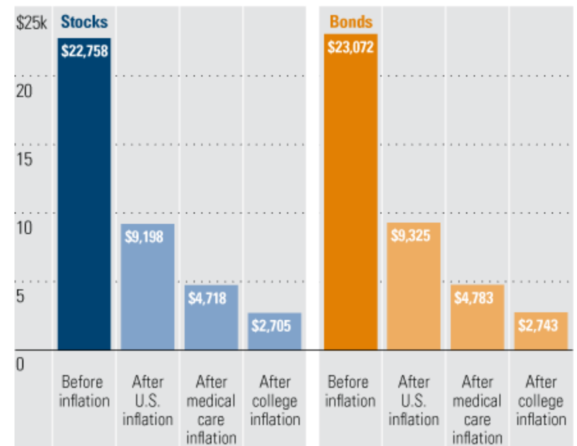
Goal-based investors may experience higher inflation. People who need to focus on savings for college or medical care may be left short, as the cost for such items often tends to rise at a faster rate than the average cost of living. Those investors might not be able to keep pace with rising costs if they do not take their real inflation rate into account when planning their investment goals.

The image illustrates the effect of three types of inflation on an investment of $1,000 in stocks and bonds: overall U.S. inflation, medical-care inflation, and college inflation. After 30 years, inflation has considerably reduced the wealth of the original investment. For example, the $1,000 invested in stocks and bonds only grew to $9,198 and $9,325, respectively, after adjusting for U.S. inflation. Alas, even more bad news for a family with children or a baby boomer nearing retirement.

Further, of the two asset classes considered, bonds provided more growth after inflation, which is unusual. Investors wishing to keep pace with inflation would typically consider a larger allocation to stocks or explore other investments that protect against inflation. However, due to the two major crises and associated stock market declines experienced during the "lost decade," stocks performed more weakly than bonds.

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. 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 bonds. Holding a portfolio of securities for the long term does not ensure a profitable outcome and investing in securities always involves risk of loss. The rates used in the analysis and their corresponding compound annual growth rates are the consumer price index for: all urban consumers (CPI-U) (3.1%), medical care (5.4%), and college tuition and fees (7.4%).

Investment of $1,000 in Stocks and Bonds Before and After Inflation Rates, 1982–2011



Source: Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and is considered to be representative of the U.S. stock market in general; Bonds—20-year U.S. government bond; Historical inflation—Consumer Price Index; Growth rates of CPI categories—non-seasonally adjusted U.S. city averages from the Bureau of Labor Statistics.

Monthly Market Commentary

Much of July consisted of market participants eagerly awaiting announcements from the U.S. Federal Reserve and the European Central Bank (ECB). The main expectation was for some form of concrete action to revitalize lackluster economies in the wake of the global slowdown. Markets soared after ECB chief Mario Draghi made strong statements, including how the ECB was “ready to do whatever it takes to preserve the euro,” but unfortunately fell sharply again when the ECB failed to actually provide any strong policy support to troubled Eurozone economies. Earnings season showed corporate earnings mostly came in better than expected, though revenue was mostly light as the European crisis continued to affect many companies.

GDP: Second quarter real GDP growth came in at an anemic, but not surprising 1.5%, down from a revised 2.0% in the first quarter. A slowdown in consumer spending and a rise in imports were the main causes of this deceleration. While many have questioned whether the U.S. might already be in a recession, the latest GDP results do not currently reveal that. At the same time, it is difficult to argue that the U.S. economy is booming.

Employment: Investors breathed a huge sigh of relief as 172,000 jobs were added in July, up from a revised 73,000 jobs in June. Most of the job growth came from business services, restaurants, health care, and manufacturing while government hiring shrank by 9,000. Unfortunately, the construction industry continued to contract from poor construction hiring in the commercial sector. The unemployment rate inched upwards slightly to 8.3%.

Housing: Housing data continued to show improvements, as July builder sentiment made its largest single-month increase in a decade. June housing starts set a new recovery high after rising 29% year-over-year, and June existing home inventories remained about 20% below year-ago levels. While low inventories have started to weigh on existing home sales, which fell 5.4% from May to June, lower inventory levels also caused a dramatic rise in median prices. Morningstar economists believe that while it is unfortunate housing is improving at such a slow pace, it still has a lot of room to expand and may drive the economy even higher as exports and manufacturing begin to slow.

Manufacturing: The purchasing manager reports in July indicated paltry gains for both U.S. and China manufacturing, while the Eurozone continued to show broad-based weakness with a 37-month low reading as European companies continued to cut employment and inventories in the face of further expected declines. More importantly, slowdowns in France and Germany suggest that further weakness lies ahead.

Auto: Auto sales were a big help for the economy in both the December 2011 quarter and the March 2012 quarter, but were essentially flat from March to June. With July’s vehicle sales of 14 million units, the auto industry continued to hold steady and will most likely not be a big help in the second half of 2012. Although sales did not accelerate, more sales were made to consumers instead of corporate fleets or rental car companies. It is worthwhile to note that consumer sales tend to occur at higher prices and are considered more indicative of economic strength.

Inflation: June’s CPI report showed that medical services and apparel prices increased, while overall energy and airline prices fell. Droughts in the Midwest continued, which could mean even higher corn and soybean prices that may further drive up the prices of items (such as pork and chicken) higher up the food chain. Unfortunately, this may hurt consumers, who were just beginning to get ahead of inflation.

Eliminate Your Value Gap

If you own a business and plan on selling it in the future, it may be wise to consider potential gaps between your own perceived value of your business and its actual fair market value. This value gap could blindside a business owner, especially one nearing retirement.

In an increasingly challenging mergers-and-acquisitions environment, the formula is simple: business owners and management teams who are highly prepared, diligent, and organized for a liquidity event (e.g., sale of company) yield more successful outcomes that are more in line with the business owner's financial goals and objectives than those who are less prepared and wait until the last moment. Receiving a business valuation from an accredited and independent valuation professional may give you more certainty surrounding your retirement plans and may eliminate this value gap.

Ideally, succession planning for your business should start earlier rather than later, as understanding the value of your business today will help prepare you for a liquidity event tomorrow. From gathering detailed information about your company to analyzing projections and conducting management interviews, the valuation process can provide you with a detailed understanding of key value and risk drivers that affect your business. The valuation professional's concluded value is the starting point in your succession and shareholder planning process. Your initial value can also be used as a catalyst to learn how short- and long-term decisions impact value over time and can ultimately change your retirement situation.

If you are interested in learning more about the business valuation process and whether a valuation is right for you, consider talking to your advisor about their relationships with business valuation specialists.

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