# Investor Insights & Outlook

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## Recent Bond Performance Explained

For investors, it comes as a surprise that bonds have recently outperformed stocks. Investors often assume that stocks offer higher returns compared with bonds. Recent market conditions, however, have proved otherwise. The image shows that while stocks have outperformed other asset classes from a return perspective since 1926, they have struggled over the last 10 years. Don't be surprised at the higher bond returns in the past 1-, 5-, and 10-years. Besides the dot-com bubble and subprime mortgage crisis in the past decade, several unique events in 2011, such as the Arab Spring, U.S. credit downgrade and the sovereign debt crisis, led to a flight to safety into government bonds. Under these circumstances, investors are advised to stick with their long-term investing strategy and be aware that asset class characteristics may deviate in the short term based on current market conditions.

### Unusual Stock and Bond Behavior 1926–2011

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. U.S. stocks are represented by the Standard and 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, long-term government bonds by the 20-year U.S. government bond, long-term corporate bonds by the Ibbotson® Long-Term Corporate Bond Index, and 30-day Treasury bills by the 30-day U.S. Treasury bill. Government bonds and Treasury bills 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. With corporate bonds an investor is a creditor of the corporation and the bond is subject to default risk. Corporate bonds are not guaranteed. Returns are compound annual returns.

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# Monthly Market Commentary

Markets in October and early November were mostly distracted from the positive economic news in the U.S. by poor earnings reports, election jitters, and Hurricane Sandy. The earnings reports have not been pretty, with negative news from slowing emerging markets, a weak Europe (and, to a lesser degree, China), and large currency swings. Although the U.S. won't remain immune to the rest of the world forever, and our fiscal situation remains in disarray, there still are a few factors that will help the domestic economy. These include Boeing's ongoing ramp-up, a nicely improved and stable auto industry, increased oil production, a relatively stabilized banking industry, and a lumbering housing industry that has finally begun to recover.

GDP: Third-quarter real GDP grew by 2%, ahead of the second quarter's 1.3% rate. Much of this improvement was due to a very strong consumer, an improved housing market, and strong government spending. Consumption, which represents about 70% of GDP, is always the most important factor, because if consumers continue to spend, businesses will have to invest in plant and equipment, inventory, and most importantly, employees.

Employment: In October, 171,000 jobs were added, sharply exceeding expectations. While this was great news, Morningstar economists believe that at the current pace of job growth, an additional 23 months is still required to recover pre-recession jobs. Employment recovery across sectors has not been consistent. The overall service sector is nearly back to pre-recession levels, while good-producing sectors (mining, manufacturing, and construction) have only recovered 15% of the jobs lost. Furthermore, massive efficiency gains in manufacturing have moved industrial production levels to near pre-recession levels, even as manufacturing has regained a measly 25% or less of the jobs lost. The unemployment rate inched upward to 7.9%.

Housing: Despite the arrival of fall, which typically brings a drop in real estate activities, home prices, new home sales, and pending home sales all showed improvement. On a year-over-year basis, the August Federal Housing Finance Agency (FHFA) Home Price Index was up 4.6%, with all nine regions in the U.S. showing positive growth. While almost always moving in the same direction, pending sales (contract executed but not closed) have exceeded closed sales by a large margin for many months, as below-market appraisals and mortgage denials caused many contracts to not close. Recently, the gap between growth in pending and closing sales has narrowed to about 2% from as much as 6%, which Morningstar economists believe points toward an improving housing market.

Manufacturing: October's manufacturing data showed gains in new orders and an increase in employment, which suggested that the manufacturing sector in the U.S. may have bottomed and is now recovering. Auto sales in October were better than a year ago, but slumped from 14.9 million units in September to 14.2 million units in October. Hurricane Sandy was most likely the cause of this shortfall, as a large portion of auto sales occur on the last few days of the month, and the area hit by the storm accounted for 20%-25% of all auto sales. Outside of the U.S., China showed meaningful improvement between September and October as the Chinese construction market continued to show signs of bottoming. Europe's manufacturing, on the other hand, continued to contract and is currently at its lowest level in 40 months.

Election results: With President Barack Obama narrowly beating out Republican challenger Mitt Romney to win a second term in office, all attention has now turned to global woes and the looming fiscal cliff. If nothing is resolved by the end of 2012, massive spending cuts and across-the-board tax increases may occur. Markets reacted negatively on Wednesday November 7th, falling by as much as 2.73%, with energy and banking sectors among the hardest hit.

# The Best Investments for Your IRA

Stocks or Bonds: Which Are Better?

Conventional wisdom holds that investors should hold bonds in tax-protected vehicles like IRAs and stocks in their taxable accounts. Intuitively, that makes sense. After all, bonds throw off a lot of taxable income, which is taxed at rates as high as 35%. Meanwhile, stocks typically generate much less income, and that dividend income is taxed at a much lower rate—generally 15%. (Long-term capital gains from stocks enjoy the same rate.)

In this instance, however, the conventional wisdom has limitations. Stocks generally produce higher returns than bonds, and thanks to the magic of compounding, the differences in performance really add up over time. That's why the return from stocks can generate a much higher tax burden than bonds over the long haul. If you're a long way from retirement, it might make more sense to hold stocks in your IRA (and bonds if you are close to retiring).

Not All Investments Are Equal

So you've got a while until you retire, and you've decided that stocks are the right choice for your IRA. That decision only gets you so far. For an IRA, not all stock investments are created equal. For example, index funds' popularity has soared over the past decade, thanks in no small part to these offerings' often rock-bottom costs as well as the fact that so many active stock-pickers routinely lag their benchmarks. Such funds may also have the benefit of very good tax efficiency, because managers of large-cap index funds tend to buy and sell infrequently. In the same vein, actively-managed funds with very low turnover often don't generate a lot of taxable gains, either. Either fund type would work well as an IRA holding. However, to the extent that you own funds that do generate a lot of taxable capital gains, it makes sense to hold them in an IRA or other tax-sheltered account. In so doing, you take maximum advantage of the IRA's key attribute: tax-deferred (traditional IRA) or tax-free (Roth IRA) compounding.

As for bonds, municipal bonds don't belong in an IRA; such funds generate income that's exempt from federal and in some cases state income tax, and their yields are generally lower than taxable bonds as a result. Meanwhile, high-yield bonds are better contenders—they generate heaps of income, but IRA investors don't have to pay tax on those distributions. Alternative asset classes may also make ideal IRA candidates. REIT funds, for example, pay out heaps of income from their underlying real-estate holdings, and none of it is tax-advantaged; thus, to the extent that you own such an offering, you'll want to be sure to stash it in an IRA or other tax-sheltered vehicle.

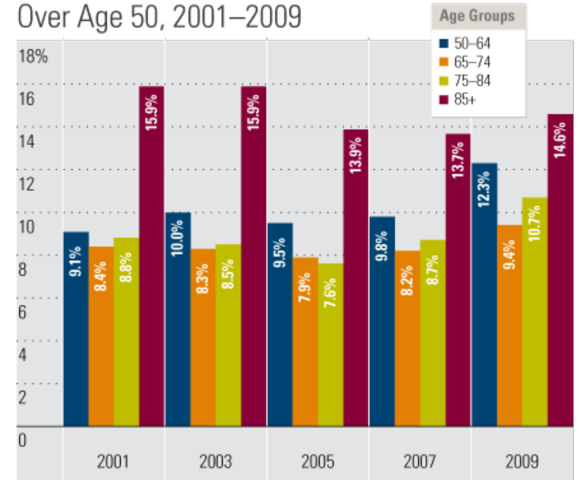
Keep the Big Picture in Mind

How you split your portfolio between stocks and bonds should be based on your risk tolerance and time horizon, not what makes sense from a tax perspective. Your goal isn't necessarily to avoid taxes, but to maximize after-tax returns. Be sure to consult with a financial advisor or tax professional for the latest rules and regulations.

Past performance is no guarantee of future results. Stocks and REITs are not guaranteed and have been more volatile than bonds. REITs typically provide high dividends plus the potential for moderate, long-term capital appreciation. A REIT must distribute at least 90% of its taxable income to shareholders annually. Real estate investment options are subject to certain risks, such as risks associated with general and local economic conditions, interest rate fluctuation, credit risks, liquidity risks and corporate structure. High-yield corporate bonds exhibit significantly more risk of default than investment grade corporate bonds. Municipal bonds may be subject to the alternative minimum tax (AMT) and state and local taxes, and federal taxes would apply to any capital gains distributions.

# Poverty Trends in Retirement

Poverty Rates for Different Age Groups Over Age 50, 2001–2009




*Report cited: "Time Trends in Poverty for Older Americans Between 2001–2009," Employee Benefit Research Institute Notes, Vol. 33, No. 4, April 2012.

This study uses the poverty threshold levels from the U.S. Census Bureau to determine poverty status. The Census Bureau uses a set of money income thresholds that vary by family size and composition to determine who is in poverty. If a family's total income is less than the family's threshold, then that family and every individual in it is considered in poverty.

Retirement for most Americans nowadays is a far cry from the legendary "golden years." Relying on Social Security alone will simply not cut it anymore, and even people who have worked and saved diligently all their lives are worried their nest egg may not be enough. The worst-faring population group, however, may be retirees who live below the poverty line.

A recent study from the EBRI* examined poverty trends among Americans aged 50 or older from 2001 to 2009. Poverty rates are highest for those aged 85 and above, since by that time most personal savings tend to deplete. Another factor that may be at work behind these numbers is the increasing level of medical expenditures as we age. Those in poverty are almost 45–55 percent more likely to suffer from various health conditions as compared with those who are not classified as poor.

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