Investor Insights & Outlook

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Risk, Not Volatility, Is the Real Enemy

What would you do if your investments lost 10% in a single day? A) Add more money to my account. B) Hold steady with what I've got. C) Yank my money; I wouldn't be able to stand any more losses.

If investors buy the right investments but sell them at the wrong time because they can't handle the price fluctuations, they may have been better off avoiding those investments in the first place. Most investors are poor judges of their own risk tolerance, feeling more risk-resilient in up markets and more risk-averse after market losses. However, focusing on an investor's response to short-term losses inappropriately confuses risk and volatility. Understanding the difference between the two and focusing on the former is a potential way to make sure you reach your financial goals.

Volatility encompasses the changes in the price of a security, a portfolio, or a market segment, both on the upside and downside, during a short time period like a day, a month, or a year. Risk, by contrast, is the chance that you won't be able to meet your financial goals or that you'll have to recalibrate your goals because your investment comes up short. So how can investors focus on risk while putting volatility in its place? The first step is to know that volatility is inevitable, and if you have a long enough time horizon, you may be able to harness it for your own benefit. Diversifying your portfolio among different asset classes can also help mute the volatility. It helps to articulate your real risks: your financial goals and the possibility of falling short of them. Finally, plan to keep money you need for near-term expenses out of the volatility mix altogether.

Investing in securities always involves risk of loss. Diversification does not eliminate the risk of experiencing investment losses.

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MORNINGSTAR

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Bill Roller is experienced in financial planning and investment analysis. He focuses his consulting practice on estate, retirement, and financial planning for businesses and individuals. Bill started BR Capital Inc. in 2003. Before that he worked for a large Wall Street firm for over nine years. He served for seven years as a U.S. Army officer in Infantry and Special Forces (Green Beret) units. Bill is a Chartered Financial Analyst as well as a Certified Financial Planner. He is the past president of the Estate Planning Council of Southwest Washington. He earned a Bachelor of Science degree from the United States Military Academy at West Point in 1982, and a MBA from the Wharton School of Business in 1991. He provides the morning and afternoon market reports and financial commentary for AM 1360 KUIK. A link to Bill's articles and interviews is available at http://brcapitalinc.com. To subscribe to articles and daily market updates go to http://brcapitalinc.com/subscribe/

Dividend Income During Downturns

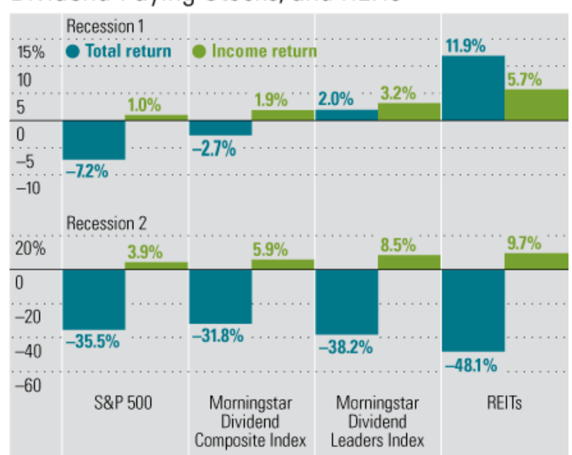
During a recession, the stock market can lose significant value. This could have a large impact on portfolio returns. Predicting the duration and extent of recessionary periods is almost impossible. During such times, income-producing investments such as dividend -paying stocks and REITs may soften losses, particularly when investors incur negative returns. This means that, if and when dividends are paid out, they have the potential to act as a cushion and are positive whether stock returns are positive or negative.

The image compares the total return and income return for the S&P 500 index, Dividend Composite index, Dividend Leaders index, and REITs for the past two recessions in 2001 and 2007. As seen in the image, dividend-paying stocks and REITs produced higher income returns relative to the S&P 500 over the given time periods (however, keep in mind that REITs are far more risky than their typical common stock counterparts). Stocks that pay dividends may serve as an income source while also providing investors with exposure to the growth potential of the stock market.

Dividends are not guaranteed and are paid at the discretion of the stock-issuing company. Diversification does not eliminate the risk of experiencing investment losses. 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 and REITs are not guaranteed and have been more volatile than the other asset classes. REITs 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. REITs must distribute at least 90% of taxable income annually to shareholders.

The Morningstar Dividend Composite Index captures the performance of all stocks in the U.S. Market Index that have a consistent record of dividend payment and have the ability to sustain their dividend payment. Stocks in the index are weighted in proportion to the total pool of dividends available to investors. The Morningstar Dividend Leaders Index captures the performance of the 100 highest yielding stocks that have a consistent record of dividend payment and have the ability to sustain their dividend payments. Stocks in the index are weighted in proportion to the total pool of dividends available to investors. Recession data is from National Bureau of Economic Research (NBER) and defined by the periods March 2001–November 2001 and December 2007–June 2009. NBER does not define a recession in terms of two consecutive quarters of decline in real GDP. Rather, a recession is a recurring period of decline in total output, income, employment, and trade usually lasting from six months to a year and marked by widespread contractions in many sectors of the economy.

Returns of the S&P 500®, Dividend-Paying Stocks, and REITs



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. S&P 500 is 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. REITs are represented by the FTSE NAREIT All Equity REIT Index®. Morningstar Dividend Composite is represented by the Morningstar Dividend Composite Index, and Morningstar Dividend Leaders by the Morningstar Dividend Leaders Index. Income return and total return are represented by the compound annual return over the given time period.

Monthly Market Commentary

The worst of the fiscal cliff crisis was averted as Congress managed to come to a deal at the eleventh hour. As part of the deal, tax rates will go up for high-income earners, and the payroll tax holiday will expire, affecting income earners across the board. The new tax rates may slow the economy, but also decrease some of the uncertainty. Markets reacted positively, with the S&P 500 jumping more than 4% in the first week of January.

GDP: The third and final estimate for third quarter real GDP growth was revised sharply higher to 3.1%, from an initial estimate of 2.0% and also higher compared with the second quarter real GDP growth rate of 1.3%. This makes it the third-best quarter of the 13-quarter recovery. Consumption and import/export figures were revised upwards, while inventories were less of a contributor than previous estimates.

Employment: In December, 155,000 jobs were added, mainly from strong growth in the health-care and construction sectors. More importantly, hours worked and hourly wage rates were also up. Taking into consideration average hours, average wages, and employment, Morningstar economists believe that total private wages grew at a stunning 0.7% in December (8.4% annualized). Given that there was limited inflation in December, these gains may flow almost immediately to consumers. Going into January, with higher taxes, this large income growth will provide consumers with a substantial cushion. The unemployment rate in December inched up slightly to 7.8%.

Housing: Original housing market forecasts for 2012 ranged from more doom and gloom to minuscule improvements. Instead, the U.S. got a year of considerable advancement, with home inventories down significantly, which has led to higher prices across the board. With inventories so low, it is now difficult to buy a home in many markets, especially on the West Coast. Home builders are also constrained by raw material prices going up, as well as a shortage of construction workers. Morningstar economists believe that home price gains of 5% or more for all of 2012 are pretty much certain, but volume-related housing metrics will slow in 2013 given these supply constraints.

Auto: Auto sales in December were at about 15.4 million units, down slightly from the 15.6 million units sold in November, which benefited from required replacements associated with Hurricane Sandy. The auto industry has been a real plus for the U.S. economy. The durable goods sales category (mainly comprised of autos), has been the single largest contributor to the economic recovery so far. While much of Europe is struggling with declining auto sales, the U.S. managed to pull out another year of very impressive growth.

Retail: Holiday sales (essentially November and December) were up 3.1% from a year ago. Sales in December showed a sharp improvement compared with November, which reflected the impact of accounting for layaway sales, Hurricane Sandy, and the timing of Cyber Monday this year. Overall, the holiday season was good, but not great. Consumer headwinds were substantial, ranging from Hurricane Sandy at the beginning of the season to worries about the fiscal cliff at the end of it. Thankfully, improved consumer incomes, falling gasoline prices, cooler temperatures, and more discounting at the end of the season, all helped boost sales.

Year-end insights: Despite odd weather patterns, presidential election jitters, and fiscal cliff concerns, 2012 was filled with much positive news for the U.S. economy. This included higher oil production, an improved auto industry, decreased commodity prices, and a stabilizing housing market. Unfortunately, the same could not be said about Europe, which entered a recession, or China, whose growth slowed dramatically. The relative strength of the U.S. economy also translated into benefits for consumers, who experienced steady employment growth, stable inflation, rising financial assets, and a nicely improving real estate market.

Money Market Fund Basics

When you invest for the long haul, whether to fund retirement or your child's college education, you should also keep a cash reserve to meet short-term demands and handle emergencies. In addition to your basic savings or checking accounts, money market mutual funds can be a great place to park that cash reserve. Money market funds invest in short-term, high-quality debt, and are among the most conservative funds available. They invest in bonds issued by extremely stable debtors, such as the U.S. government, and large, financially sound companies.

Money market funds typically pay a percentage point more than money market accounts from banks. You'd get even less interest if you put your cash in a checking or savings account. Keep in mind, though, that unlike consumer bank accounts, money market funds are not insured by the Federal Deposit Insurance Corporation (FDIC). However, they are regulated by the United States Securities and Exchange Commission (SEC), which enforces strict limits on the types of investments these funds can make. Consequently, it is unusual for a fund to take a hit to its principal, but, like with any other investment vehicle, it is still possible to lose money. When choosing a money market fund, be sure to bargain hunt: Low-expense funds have an edge that's hard to beat. Also, be sure to find a package that works for you. In general, money market funds have low minimum investment requirements and may offer limited check-writing privileges, but these characteristics vary widely from fund to fund.

Investors should read the prospectus and carefully consider a fund's investment objectives, risks, fees, and expenses before investing. Money market funds are portfolios that invest in short-term money market securities in order to provide a level of current income that is consistent with the preservation of capital.

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