Investor Insights & Outlook

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Investors May 'Prefer' to Look Elsewhere for Yield

With yield so scarce today, investors are branching out into different asset classes in their search for income. Many investors have set upon preferred stock, a hybrid security usually issued by highly leveraged companies, such as financial institutions, telecoms, and utilities. Preferred stock has characteristics of both bonds and stocks. Like stocks, preferreds are traded daily on an exchange. Like bonds, they pay fixed income on a regular basis (usually quarterly), but typically they do not offer as much capital appreciation potential as common stock. In the capital structure, preferred stock is senior to common stock but junior to corporate bonds, and preferred shareholders have no voting rights.

Preferred stock is not without its headwinds. In fact, there are many significant risk factors that investors must consider. Heavy exposure to financials, regulation changes, and rising interest rates are foremost on this list. Preferreds are sensitive to interest rates, but unlike bonds, they are at risk in both directions. When rates fall (presently an unlikely event), issuers often call shares to reissue at lower, more favorable rates. When rates go up, preferred stock share prices fall. Preferreds also have call options backed in, usually about five years after issuance, but some can be called even before then. Issuers can suspend dividend payments during rough periods, and in the event of bankruptcy, owners will walk away with nothing (for example, investors in preferred shares from Fannie and Freddie lost everything). In conclusion, preferred stocks' high yields may be alluring to income-seekers, but investors should approach this space with caution.

Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than other asset classes.

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Advisors Corner

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Mutual Fund Tax Bills Are Rising

Mutual fund investors' tax bills have been on the rise again recently. The average capital gains distribution (a payment to shareholders of profits realized on the sale of a fund's securities) for U.S. equity funds based on data as of April 2014 is 19.3% of assets, compared with, for example, 6.9% back in 2007. These recent distributions are among the largest seen since the start of the financial crisis in 2008.

The reason for those payouts is of course a good thing. The payouts mean that funds have produced solid returns for a few years running. The distributions were small in 2008, 2009, and 2010 because capital gains were offset by realized losses during the financial crisis. However, most of those losses are long gone.

Mutual funds are required to distribute their capital gains once a year. All of the realized gains are tallied while the realized losses and loss carry forwards from the previous year are subtracted to arrive at the total sum to be paid out. The distributions are made in equal proportions to all shareholders regardless of when they bought the fund. Then all the fund holders who own the fund in a taxable account have to pay taxes on those distributions—even if they reinvest their distribution.

What does all of this mean? Well, mutual fund investors should consider strategies for dealing with future payments. Most funds may still be sitting on sizable gains, so it's quite likely that payouts will continue to grow as funds sell their winners. Thus, fund tax bills can be expected to grow. That's a bad thing, because you'll have more money at the end of the day if you can postpone paying capital gains as far into the future as possible. The reasons are twofold: First, the time value of money means that money in today's dollars is worth more than in the future because inflation will have eroded its value. In addition, if you hold on to the money, it can compound over time in your fund, thus earning you more money.

Here, then, are a few things you can do to limit your tax bill.

1) Max out on tax-sheltered accounts. Taxable distributions are not a problem for 401(k)s, 403(b)s, and IRAs, so invest as much as the law will allow before you put money in taxable accounts.

2) Consider tax-managed funds for your taxable accounts. Tax-managed funds do a great job of avoiding making distributions because they realize losses on some holdings when they have to realize gains on others. After taxes are figured in, these funds generally put up superior returns.

3) Consider exchange-traded funds (ETFs). They don't have all the strategies available as tax-managed funds, but they do have some unique features that help reduce their tax bills. Just make sure you've chosen one that is diversified, has low costs, and has low turnover.

4) Don't buy funds that have had huge returns over the past three years. Buy a fund with huge gains and you're going to get a huge tax bill regardless of whether you make any money yourself. So, tread carefully in hot areas. If you have your heart set on such a fund, at least put it in an IRA or 401(k).

Investors should read the prospectus and carefully consider a fund's investment objectives, risks, fees, and expenses before investing. It is important to note that ETFs are not immune from capital gains distributions; ETFs may make capital gains distributions if changes in the underlying index occur. 401(k) and IRA plans are long-term retirement-savings vehicles. Withdrawal of pretax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Please consult with a legal, financial, or tax professional for advice specific to your situation.

Monthly Market Commentary

Overall, April data brought some very welcome good news. April auto sales looked great, stacking together two 16 million-plus unit sales months in a row. Pending-home sales looked much better too, indicating that the decline in existing-home sales may be nearing its end. Employment data looked great, but not perfect. Manufacturing continued to make modest progress with another month of increasing ratings from purchasing managers in the sector. Even chain store sales managed year-over-year growth of 3.1% in the latest period, their best performance since December.

GDP: First-quarter GDP growth was sharply below expectations, barely at 0.1%. Just about every category was flat or down, with only consumption of services saving the U.S. from an outright decline in GDP. However, a lot of data points from April (enumerated above) pointed sharply higher. All this may suggest that growth of 3% or more is possible in the second quarter, offsetting the sting of a disappointing first quarter. However, these numbers are not the start of a new normal of rapid and always-accelerating growth. Instead, growth for the full year is likely to remain stuck in a 2.0%–2.5% range.

Employment: April's nonfarm job growth of 288,000 plus revisions to the previous two months was a pleasant surprise. However, the longer-term trend, using an average of three months of data compared year over year, has not broken out of its slow upward trend, even with April's great performance. The report did contain one ominous dark could: Hourly wage growth was nonexistent for the second month in a row. Adjusted for inflation, the United States has seen two months of hourly wage declines. The inflation-adjusted wage data (combining employment, hourly wages, and hours growth) shows that the economy is still running a little below average.

Longer-term, we may be talking about job shortages, not the unemployment rate. The U.S.-born working-age population numbers (22- to 62-year-olds) are slated to decline for the first time in decades sometime in 2015. Spot shortages are already beginning to creep up in skilled machinists, airline pilots, and truck drivers (average age 55). Even homebuilders are complaining about a lack of skilled workers. Some of this is already becoming visible, with the unemployment rate dropping to 6.3% in April (from 6.7% the previous month). That rate could drop to under 6% by the end of 2014.

Housing: The housing market hasn't been doing well for some time, partially because of higher prices and higher mortgage rates and partially because of the weather. The numbers for March transactions, new and existing, were horrific. Still, there was one ray of hope with a decisive turn in pending home sales, which were up 3.4% in March, the first improvement in eight months. Pendings are generally a reliable predictor of existing-home sales. The gap between these two indicators is beginning to narrow sharply, so existing-home sales should be bottoming out soon, too. Also, better permits data points to improved housing starts in the months ahead.

Consumption and Personal Income: Consumption has been stuck at the 2% level for some time, but that number has begun to break out over the past two quarters. Spending growth is outpacing incomes again at a relatively healthy pace. While the two metrics can become untethered for a few months, longer-term they do tend to move in tandem. So in the months ahead, consumption will need to come down or incomes will need to come up.

Trade Deficit: Overall, the trade deficit narrowed to $40.4 billion in March from $41.9 million in February. Additional oil and gas production and shipments explain why the trade deficit has held steady or even improved over the past couple of years. Petroleum represents about 5% of all U.S. exports, which are up modestly over the past few years, while petroleum-related imports have fallen from 14% to 10% in real terms over the past three years.

Tune Out the Noise

There's a reason that investors tend to only hear about "looming" market doom or "imminent" market growth. While many news outlets have incentive to draw viewer attention with wildly bullish or bearish predictions, these sensationalized views may be a distraction to a sound investment approach. When tempted to make a radical change to your investment portfolio based on these headlines, it is important to recall some basic fundamentals to keep your plan on track.

Drown out the noise. Market movements are notoriously difficult to predict. The media outlets that scream the loudest are not always the most accurate. The fallout from attempting to time the market in response to one of these predictions can be dangerous to your portfolio.

Look, but don't stare. While it's important for investors to know the performance of their accounts, short-term market fluctuations can be quite volatile. While the probability of realizing a loss within any given day is high, the likelihood of realizing a loss historically has decreased over longer holding periods. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Stay focused on the long term. Investors who have taken the time to determine a sound investment plan based on specific goals and risk tolerances are best advised to stick to that plan. While it may not always grab headlines, a sensible, tailored investment plan may be the best solution to meeting long-term goals.

Holding a portfolio of securities for the long term does not ensure a profitable outcome, and investing in securities always involves risk of loss.

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