Investor Insights & Outlook

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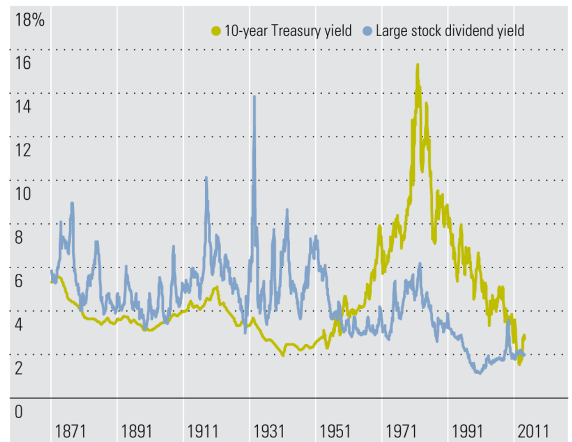
Large Stock Dividend Yield Versus 10-Year Treasury Yield

In the recent context of likely-to-rise-at-any-time interest rates, it may be interesting to take a look at the historical relationship between stock and bond yields. As illustrated in the image, stock dividend yields were much higher than 10-year government-bond yields before 1957, with dividend payouts a form of compensation for the additional risk of investing in stocks.

In the more modern period, this relationship has changed. As capital appreciation became a bigger driver of stock performance, bonds became the main engine for potentially steady income generation. After 10-year Treasury rates significantly declined following the 2008 financial crisis, stocks yielded more than 10-year Treasury bonds for the first time since 1957. Recent rising interest rates, however, have pushed government yields above stock dividends once again.

Stock and Bond Yields
January 1871–March 2014



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. Stocks are not guaranteed and have been more volatile than the other asset classes. Dividends are not guaranteed and are paid solely at the discretion of the stock-issuing company. 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. U.S. government bonds may be exempt from state taxes and income is taxed as ordinary income in the year received. With government bonds, the investor is a creditor of the government. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest-rate changes.

Data: Large stock dividend yield is represented by monthly S&P Composite Index. 10-year Treasury yield is based on the monthly yield of 10-year government bonds. Both indexes are from Robert J. Shiller's Data Library

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Maxing Out a 401(k) … or Not?

Maxing out a 401(k) is an article of faith for many higher-income workers. Unlike IRAs, where income limits may curb contributions, employees can generally contribute the maximum allowable amount to their 401(k)s regardless of how much they earn. In 2014, people under age 50 are able to contribute $17,500, and those over age 50 can make a $23,000 contribution. That's a significant amount that is eligible for the tax-deferred compounding that 401(k)s afford.

However, an IRS regulation referred to as nondiscrimination testing may limit the 401(k) contributions of highly paid workers, especially for smaller companies with a lot of executives and a small number of lower-level employees. Nondiscrimination testing is an IRS rule intended to ensure that highly compensated employees, or HCEs, aren't benefiting disproportionately from the tax breaks that come along with investing in 401(k) plans, while non-HCEs are not taking advantage of them. For 2014, an HCE is defined as someone who had compensation of more than $115,000 during the year or who owns 5% or more of the company. The tests are performed by the plan sponsors by counting contributions by both HCEs and non-HCEs and performing a few mathematical calculations. If, based on these numbers, a company's 401(k) plan fails the nondiscrimination tests, employees who are classified as HCEs may not be able to make the maximum allowable contribution.

When a 401(k) plan fails the nondiscrimination tests, the company needs to take corrective action. In most cases, the company chooses to return a portion of HCEs' contributions. The refund amount would be taxable in the year in which it was received, along with any investment earnings on that excess contribution amount. Unfortunately, some plans fail nondiscrimination testing year after year, meaning that some employees can't take full advantage of all of their tax-sheltered options. For employees in this situation, there are a few options to explore, including the following.

Work to Enact Change: It is important to make the higher-ups in the company aware that employees are not happy when their retirement contributions are being curtailed. The possibility exists that the benefits administrator isn't properly categorizing HCEs and non-HCEs, which in turn can affect the plan's ability to pass the nondiscrimination tests. Employees can also lobby for improved non-HCE participation. The benefits administrator can be asked to consider an auto-enrollment feature and to step up educational efforts in order to encourage participation.

Maximize Other Options: For participants who have gotten a refund of a 401(k) contribution due to the failure of a nondiscrimination test, the next step may be to put that money to work elsewhere. Funding an IRA is a place to start. Married employees may also want to make sure their spouse is taking maximum advantage of his or her options by fully funding a 401(k) and/or IRA. In addition, a reasonable level of tax efficiency may be obtained (albeit without the benefit of tax-deductible contributions) by investing in a taxable account.

Ask for a Heads-Up: If a company’s plan has a history of failing nondiscrimination testing, employees may want to ask the benefits administrator for midyear guidance on whether the plan is likely to pass or fail for that particular year. If it appears that the plan won't pass, it may be better to stop contributing preemptively rather than risk an excess contribution and refund. After all, participants might be paying an extra layer of fees to invest inside of the 401(k) and might not have tax-efficient investment choices within that 401(k).

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 financial or tax professional for advice specific to your situation.

Monthly Market Commentary

Recent economic news was mixed, with strong U.S. auto sales and decent employment growth, but also with negative first-quarter GDP growth. The European Central Bank made headlines by lowering its key interest rates and announcing measures designed to ensure price stability and to support lending.

GDP: The U.S. economy contracted in the first quarter, after all. As many economists anticipated, first-quarter GDP growth was reduced from a 0.1% growth to a 1.0% decline. Although many categories shifted, it was inventories that really moved the needle. However, inventories are notoriously volatile, especially difficult to measure and to seasonally adjust. Wide swings in the data more likely represent measurement errors and timing issues and not necessarily things happening in the real economy. Given the solid growth rates in employment and consumption, the first quarter would have shown some modest growth if it weren't for the inventory subtraction.

Employment: The economy added 217,000 total jobs in May compared with the 12-month average of 194,000 jobs. Private sector jobs grew about 2.05% year over year, and the nonfarm payrolls, which add government to the mix, grew 1.72%. Both of those numbers are consistent with GDP growth in the 2.0%–2.5% range.

Total employment finally made a new all-time high and recaptured every job lost during the recession. It only took just under six and a half years, the longest recapture period in the post-World War II era. And that politely ignores the fact that the population is quite a bit greater than it was over six years ago. The performance has been very uneven, too, with many, many industries still operating below peak levels.

European Central Bank: Sagging economic growth and falling inflation finally forced the ECB to take decisive action to head off a Japan-like bout of deflation. Myriad rates were cut, negative interest rates were implemented for bank reserves, and new low-cost lending programs were rolled out. By putting a negative rate on deposits, the central bank hopes to force banks to lend more cash, which might generate more economic activity. All of this should stimulate the European economy and depress the euro, which would aid European exports. Equity markets around the world reacted well to this news. In general, easy money policies tend to help emerging markets, and the potential for a stronger export market in Europe provided a double dose of good news.

Housing Prices: Home price growth generally peaked last October and November, with the broader FHFA index down quite significantly and the CoreLogic data showing almost no change. Home affordability has slipped, mostly because of higher prices, but also because of higher mortgage rates. Less affordability means fewer transactions and less housing-related economic activity. The economy needs to work out a balance, with some level of price appreciation that keeps both investors and consumers in the market, but without so much price appreciation that no one can afford a home.

Consumption and Personal Income: Consumption growth, adjusted for inflation, dropped 0.3% in April, which was below expectations and is quite disconcerting taken in isolation. Incomes continued their nice upward slope, which should provide fuel for consumer spending in the months ahead.

Trade Deficit: The news on the trade front was not good, although monthly data can be highly volatile. The trade deficit for April was $47.2 billion, its highest level in the past two years and higher than the upwardly revised $44.2 billion for March. The widening deficit was a combination of a 0.2% decline in exports and a 1.1% surge in imports. Unfortunately, this data indicates further downward potential in the first-quarter GDP estimate and even more pressure on the second-quarter report.

Financial Aid for College: A Few Tips

Key to understanding financial aid eligibility is learning how financial aid formulas work. They're rather complex and vary from school to school, but they basically use answers to questions about family income, assets, and size to help arrive at a special number known as the expected family contribution, or EFC. The EFC represents the amount of tuition, fees, and other college costs the family is expected to cover based on its financial situation and other factors. Not all assets are counted when calculating the EFC (for example, assets held in retirement accounts don't count).

However, income plays a far greater role than assets in determining EFC. As much as 47% of income may be used in calculating a family's EFC, whereas parental assets are assessed at a maximum of 5.64%, and student-owned assets at a maximum of 20%. Financial-aid awards are based on the previous calendar year's income, so some families use strategies to reduce income the year before applying. For example, if one parent is considering retiring or going back to school, doing so will likely reduce the family's income, thus increasing aid eligibility. A parent also may ask that a work bonus be postponed to reduce income that counts against aid.

One common mistake families make is selling securities the year before the student enrolls as a way to cover college costs. But any capital gains from the sale count as income in the following year's financial aid calculation, so it may be best to sell securities the year before the base year (in other words, two years before the student enrolls), when the proceeds won't be counted as income.

This should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

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