Investor Insights & Outlook

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Not All Index Funds Are the Same

The choice to use index funds rather than actively managed funds is a significant one. Index funds tend to be rather straightforward, easy-to-own, and cost-effective investment vehicles. But, just like actively managed funds, index funds also have their differences that investors should be aware of.

Cost Still Counts. Different index funds can charge different fees. Funds that are otherwise virtually identical (meaning they track the same index) can nonetheless produce different returns based on their fees, because fund fees are deducted from returns. This cost difference can have a significant effect on fund performance when compounded over time.

The Challenges of Tracking an Index. Tracking error is the degree to which an index fund fails to mirror its benchmark's performance during a given time period. As the components and weightings of an index change over time, the fund must buy and sell holdings in an attempt to match it, and some funds may do this better than others.

Subtle Index Differences. Index funds within the same category may not track the same index. Consequently, two index funds that may sound very similar could actually have very different portfolios and performance numbers.

The investment return and principal value of mutual funds will fluctuate and shares, when sold, may be worth more or less than their original cost. Mutual funds are sold by prospectus, which can be obtained from your financial professional or the company and which contains complete information, including investment objectives, risks, charges and expenses. Investors should be read the prospectus and consider this information carefully before investing or sending money.

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Advisors Corner

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Monthly Market Commentary

In recent economic data, employment matches expectations, manufacturing flattens after a period of decline, and auto sales growth continues to moderate.

Employment: The U.S. economy added 223,000 jobs in April, matching expectations. However, it wasn't all good news; the March estimate was reduced from 126,000 jobs added to just 85,000, providing a much easier set of goalposts to hit for the April report. Furthermore, hourly wage growth, at least on a month-to-month basis, was surprisingly weak with just 0.1% growth or 1.2% annualized. On the positive side, the unemployment rate continued to trend down, ending April at 5.4%, down from 5.5% a month ago and 6.2% a year ago. This is the lowest reading in seven years. For a change, the rate went down exclusively because new jobs were added even as 166,000 people entered the work force in April. The higher percentage of people looking for jobs is a sign of increased consumer confidence.

Looking at private sector job growth, which excludes the much slower-growing government sector, the three-month average, year-over-year growth rate remains relatively high at 2.6%, which is down just a touch from recent highs and still above the 2.4% average growth rate of the past 12 months. Those year-over-year growth rates are likely to continue deteriorating modestly in the months ahead.

GDP: The U.S. GDP report of just 0.2% GDP growth in the first quarter was disappointing to everyone, as falling oil drilling activity ruined a report that was already expected to be hit hard by bad weather and West Coast port-related activities. Drilling activity pushed GDP growth down by 0.8%, about the size of the negative surprise. Still, we wouldn't be too upset with a GDP report that shows four-quarter-over-four-quarter growth of over 3%. Seasonal factors and weather have really confounded economists and statisticians, who tend to favor the sequential quarter-over-quarter growth methodology.

The individual GDP component factors weren't too far off of consensus forecasts. Consumption growth was cut in half in a widely expected drop from 4.4% to just 1.9% growth between the fourth quarter and the first quarter. At almost 70% of GDP, that fall single-handedly took off 1.7% from the GDP growth rate (contribution from 3% to 1.3%). The rapid deterioration in consumption, however, was widely expected. Morningstar economists still predict that U.S. GDP will grow at a rate of 2.0%–2.5% in 2015.

Manufacturing: The overall ISM Purchasing Manager Index, a great leading indicator of manufacturing activity, was flat in April at 51.5, after falling for five consecutive months. At a reading of 51.5, the metric shows that more businesses are seeing an increase in activity versus a decline. Still, the number, at least on the surface, disappointed analysts who expected a weather- and port-related bounce to 52.2. That said, the April report was a bit stronger than it looked. New orders—the leading part of the index—increased from 51.8 to 53.5, and current production moved from 53.8 to 56. Exports and imports also showed nice increases, though these are not used in calculating the composite index.

Auto sales: While auto manufacturers were trumpeting good April numbers, the auto recovery is looking a little long in the tooth. The auto sales for April were about 16.5 million units, which marks a 3.1% annual increase. That's down from the 3.8% rate reported in March. It is now apparent that auto sales growth has peaked and further year-over-year increases will be modest, indicating that the auto industry will have limited impact on GDP and employment going forward.

Key Reasons Why a Taxable Account May Be Underrated, Part 2

In a year like 2008, when stocks were badly in the dumps, the ability to engage in tax-loss selling was a rare silver lining.

Reason 4: You may be able to enjoy no- or low-tax withdrawals.

In addition to being able to keep your tax costs down while you own the securities in a taxable account, currently low capital gains rates also help you limit your tax costs when you eventually sell them. As recently as the late 1990s, a 20% long-term capital gains rate applied to investors in the 28% income tax bracket and above. Now, only investors in the very highest income tax bracket (39.6%) pay a 20% long-term capital gains rate; investors in the 25% to 35% brackets pay 15% and investors in the 10% and 15% brackets currently owe no taxes on long-term capital gains.

Reason 5: You'll have more control over your tax bill in retirement.

The ability to pull your money out with limited tax liability (because capital gains rates are pretty benign right now) can prove particularly beneficial when you begin taking money out of your accounts during retirement. You'll owe ordinary income tax on distributions from traditional 401(k)s and IRAs during retirement, and the timing and size of those distributions will be out of your control once you have to begin taking required minimum distributions (RMDs). By diversifying your asset mix across taxable and Roth accounts, you'll help ensure that at least some of your distributions will come out with low or no tax ramifications.

Holding taxable assets in addition to tax-deferred and Roth also helps ensure that, if you determine that you want to convert some of your Traditional IRA or 401(k) assets to Roth, you'll be able to pay the conversion-related taxes without having to dip into your IRA/401(k) funds, thereby sidestepping further taxes.

Reason 6: Your heirs will receive a step-up in basis.

Another key advantage to investing inside of a taxable account is that your heirs will be able to take advantage of a step-up in cost basis, essentially wiping out any capital gains tax liability that you racked up over your own holding period. That means that when they inherit assets from you, the taxes they'll eventually owe when they sell will be calculated by looking not at your purchase price but what they were worth at the time of your death. Even if your heirs end up selling the inherited assets shortly thereafter, you've still reduced the drag of taxes on your overall estate.

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. Direct contributions to a Roth IRA are not tax-deductible but may be withdrawn free of tax at any time. Earnings may be withdrawn tax and penalty free after a 5 year holding period if the age of 59 1/2 (or other qualifying condition) is met. Otherwise, a 10% federal tax penalty may apply. This is for informational purposes only and should not be considered tax or financial planning advice. Please consult with a financial or tax professional for advice specific to your situation.

A municipal bond investor is a creditor of the issuing municipality and the bond is subject to default risk. 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.

Investing does not ensure a profitable outcome and always involves risk of loss. There is no guarantee that diversification or asset allocation will protect against market risk. These investment strategies do not ensure a profit or protect against loss in a declining market.

Retirement Distribution Pitfalls: Income-Producing Securities

Accumulation is a key facet of reaching your retirement goals. However, we tend to see far less about portfolio drawdown, or decumulation—the logistics of managing a portfolio from which you're simultaneously extracting living expenses during retirement. This can be even more complicated than accumulating assets.

Pitfall: One of the big mistakes of retirement distribution can be relying strictly on income-producing securities to meet income needs. Sticking exclusively with income distributions can leave retirees beholden to the current interest-rate environment. We've seen that problem in sharp relief during the past several years, as income-oriented investors have been forced into riskier areas, such as emerging-markets bonds, to scare up the income they need.

Workaround: The bucket approach to retirement income is essentially a total-return approach that relies on regular rebalancing to provide income for living expenses. Using such a structure, a retiree would own bonds and dividend-paying stocks but would also own other stock types, including those that don't pay dividends. Such a strategy could potentially provide a better-diversified portfolio than the income-only approach for some retirees, and may also allow a retiree to enjoy a fairly stable standard of living.

All investments involve risk, including the loss of principal. There can be no assurance that any financial strategy will be successful. Diversification is an investment method used to help manage risk. It does not ensure a profit or protect against a loss. This is for informational purposes only and 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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