Investor Insights & Outlook

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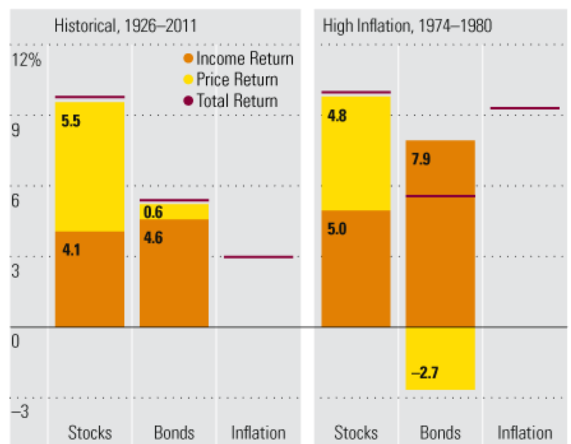
Dividends and Inflation

As an investor, you may ask if an allocation to dividend stocks in your retirement portfolio will help keep up with inflation. Examining stock returns during periods of high inflation may answer this question. Dividend-paying stocks may offer benefits such as stability through income return and inflation protection. While stock prices tend to be volatile, dividends may serve as a stable component of total return and may provide better inflation protection compared with bonds. Between 1974 and 1980 (high inflation period), the average rate of inflation was 9.3%, much higher than the historical rate of 3%. During this time, bonds yielded 7.9% from income, but prices declined by 2.7%, resulting in a total return of 5.6%—way short of inflation. On the contrary, stocks returned a total of 10%: 5.0% from dividend income and 4.8% from price return, outpacing inflation for this time period.

Performance of Stocks and Bonds Relative to Inflation



The 1974–1980 time period was chosen as representative of high inflation because it contains multiple consecutive years when inflation was 5% of higher (except 1976). The sum of the price return and income return may not equal the total return due to compounding. Past performance is no guarantee of future results. Dividends are not guaranteed. Diversification does not eliminate the risk of experiencing investment losses. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. 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 are not guaranteed and have been more volatile than the other asset classes. Stocks are represented by the Standard & 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. Bonds are represented by the 5-year U.S. government bond and inflation by the Consumer Price Index.

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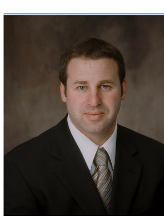

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Jason is Senior Partner and Fixed Income Securities Specialists with Kerntke Otto McGlone Wealth Management Group. He is a Certified Financial Planner (TM) professional and a Registered Investment Advisor Representative.

He holds a Bachelor of Science Degree in Economics from Northern Michigan University, and earned his Master of Science in Financial Services (MSFS) degree from the Richard D. Irwin Graduate School at The American College in Bryn Mawr, Pennsylvania. This commitment to higher education and professionalism puts Jason in a select group who has reached this level of academic achievement in financial services, and puts him in a position to address a broad range of issues when working with clients.

Jason worked as an independent financial advisor for Ameriprise Financial for 9 years. He was a member of their Advanced Advisor Group until 2007 when he became a founding partner at Kerntke Otto McGlone Wealth Management Group.

Takeaways for Retirees from the Recent Market Drop

A bear market might be good news for young investors looking to buy stocks on the cheap, but budget-priced stocks are thin gruel for retirees and pre-retirees who are relying on their portfolios to fund living expenses. A deep and protracted down market, such as the one we encountered in 2008 through early 2009, carries some takeaways for retired investors or those looking to retire within the next few years.

Get Used to Low Yields (as if you weren't already): True, some market watchers had been warning about the potential for higher interest rates at some point in the not-too-distant future. But that eventuality became even more distant when the Federal Reserve announced that it will hold interest rates near zero through the middle of 2013. That's good news for borrowers and owners of riskier assets, such as stocks, but it's bad news for yield-starved savers.

As a retiree, you probably don’t want to hold more cash than you need to fund one to two years' worth of living expenses, as the opportunity cost of holding too much cash is extreme. Also, don't put up with nonexistent yields from your local bank; shop around and be willing to be flexible. For example, you can create a two-part short-term fund consisting of true cash combined with a high-quality short-term bond fund.

Don't Be Too Quick to Cast Out Treasuries: In recent months there's been a lot of trash talking going on in the Treasury market. Some investors have been avoiding the bonds or even shorting them, saying the bonds' yields are too low and the U.S. deficit is too high. There is also fear that Treasuries will get creamed in a rising-rate environment. And, in the latest bit of ignominy for Treasuries, Standard & Poor's said they can no longer be considered a "risk-free asset."

But the market's recent swoon telegraphed something loud and clear: In a true flight to safety, very few assets will hold up better than U.S. Treasury debt, downgrade or not. That's not to say Treasuries are a screaming buy at this point, and yields are more anemic than ever. But it does argue for not getting too heroic about purging them from your portfolio altogether. If your goal is to find an investment that will zig when your stocks are zagging, it's hard to argue that Treasuries don't deliver.

A Well-Thought-Out Asset Allocation Is Your Best Friend: If you're retired or getting close, by far the best way to ride out periods of market weakness is to pay due attention to your asset allocation and cash reserves. The bucket approach to staging retirement portfolios, whereby you stash enough to cover your near-term expenses in ultra safe securities and hold the rest in long-term securities like bonds and stocks, is an intuitive way to back into the right appropriate asset allocation.

Dollar-Cost-Average Into Inflation Protection: If gloom over the strength of the global economy continues to worsen, inflation-conscious investors might be able to add inflation protection to their portfolios at more advantageous prices than when inflation was grabbing all the headlines. Dollar-cost averaging into investments such as TIPS or commodities will help reduce the odds of buying into inflation fighters when their prices are lofty.

There is no guarantee that diversification, asset allocation and dollar-cost averaging will protect against market risk. These investment strategies do not ensure a profit or protect against loss in a declining market. In addition, since investing by dollar-cost averaging involves continuous investment in securities regardless of fluctuating prices, investors should consider their financial ability to continue purchases through periods of both low and high price levels.

Be a Better International Investor

International funds have received a lot of attention in recent years, and this should come as no surprise. For starters, it has become increasingly common for investors to build multi-fund international portfolios rather than rely on individual foreign offerings for all their overseas exposure. Further, international funds have posted exceptional gains in recent years (except in 2008 and 2011). This may sound good if a significant part of your portfolio is devoted to international funds, but be sure the popularity and performance of overseas offerings hasn't made you complacent.

In fact, it's just as important to periodically reexamine the parts of your portfolio that have done well and reevaluate the portions that have lagged.

If you do take on international funds, remember to keep both your near-term expectations and your overseas exposure in check. You can also consider conservative foreign funds.

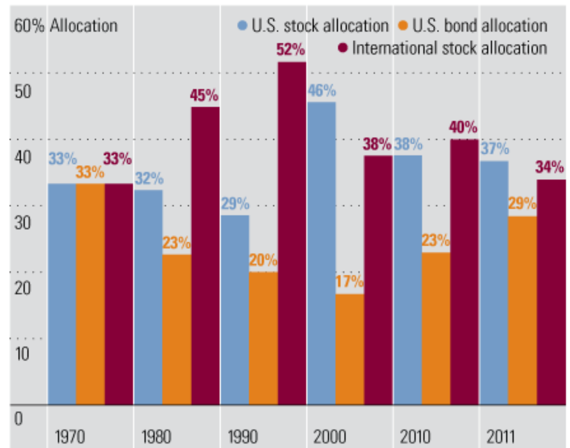
The first step is to set reasonable expectations for the short- to mid-term prospects of international funds. The superior relative gains posted by various types of overseas offerings in recent years may not be sustainable in the long run, as illustrated by weak international performance in 2008 and 2011.

When superior performance of overseas offerings does happen, check to see whether their overall foreign exposure exceeds the upper end of their international allocation range. A great portfolio performer can take on a larger percentage than you intended. Keeping an eye on your international allocation can help lower the overall risk of a portfolio.

The illustration paints a rather clear picture of this. In 1970, this portfolio began with an equal allocation to international stocks, U.S. stocks, and U.S. bonds. However, due to the strong performance of international stocks during the 1980s and 1990s, allocation to this asset class jumped to 52%. While many might overlook this shift in international exposure, keep in mind that international stocks have historically been riskier than their U.S. counterparts. As a result, the portfolio may take on an additional level of risk.

If you need to rebalance your overseas portfolio to reduce overall risk, or seek more foreign exposure, consider conservative foreign investment vehicles. Aggressive international investments have a higher probability of incurring damage during a prolonged downturn. Investing in conservative foreign funds can help balance this risk.

Importance of Rebalancing



Weights may not add up to 100% due to rounding.

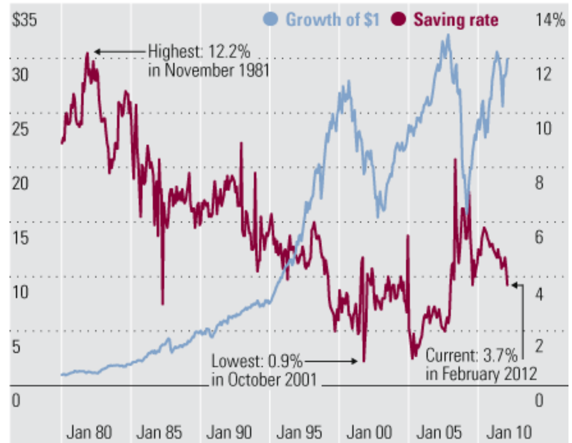
Diversification does not eliminate the risk of experiencing investment losses. This is for illustrative purposes and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while returns and principal invested in stocks are not guaranteed. International investments involve special risks like fluctuations in currency, foreign taxation, economic/political risks, and differences in accounting and financial standards.

Source: U.S. stocks are 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. International stocks are represented by the Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index. U.S. government bonds are represented by the 20-year U.S. government bond.

The Personal Saving Rate

Saving is an important part of any sound financial plan. In order to measure consumer spending and saving, the Bureau of Economic Analysis publishes personal income, expenditure and saving statistics, including the personal saving rate. This saving rate is calculated by taking disposable income (income after taxes), subtracting personal consumption expenditures, and dividing the result by personal disposable income. The saving rate has been generally trending downward for the past few decades. Recently, the saving rate was 3.7% in February 2012, extremely low when compared with previous levels. As the image illustrates, it would seem that when the market is in trouble, consumers get scared, spending less and saving more; the opposite happens when the market is doing well. However, even if the economy is now on the way to recovery, it's probably not a good idea to stop saving.

Personal Saving Rates and the Market
January 1980–February 2012



This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Returns and principal invested in stocks are not guaranteed. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment advice. Please consult with your financial professional regarding such services.

Source: The market is represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Saving rate data from the U.S. Department of Commerce, Bureau of Economic Analysis, through the Federal Reserve Bank of St. Louis (FRED® database).

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