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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Jim has more than 16 years of experience in the financial services industry. He started his career with Ameriprise Financial where he became a member of their Advanced Advisor Group. In 2007 he became a founding partner of Kerntke Otto McGlone Wealth Management Group. Jim's primary focus is working with individuals and families to achieve their goals and dreams through a long term consultative relationship.

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.

Fund Flows and Asset Class Performance

Over the last 20 years, markets have experienced many shocks and recessions, including the Asian currency crisis, the Russian debt default, the dot-com crash of the early 2000s, and the recent global financial crisis. When these events occur, investors frequently attempt to reduce (or increase) investments to certain asset classes in order to lower exposure to (or take advantage of) the situation.

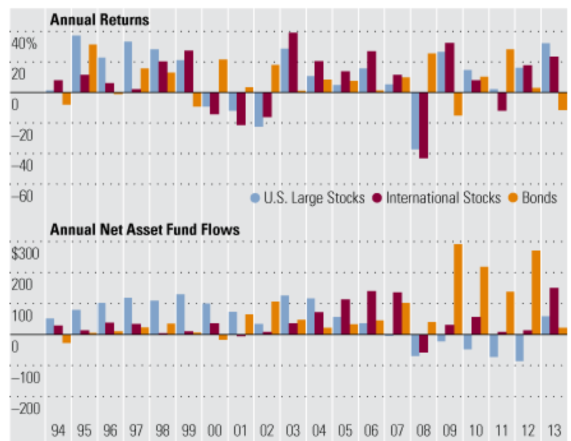
In 2008, the global financial crisis caused U.S. large stocks and international stocks to perform poorly, with losses of 37.0% and 43.1%, respectively, while bonds rose by 25.9%. In the wake of the recession, bonds performed very well in 2011, returning 28.2% as concerns about a possible double-dip recession grew. In the same year, international stocks fell 11.7%, most likely the result of events such as the sovereign debt crisis that rippled throughout the global landscape.

For all asset classes, demand and supply determine the market price of an investment. Understanding this trend may help investors ascertain how an asset class fits into their portfolio. Starting in 2007, annual net asset fund flows into U.S. stock funds became negative and stayed that way through 2012. Flows into bond funds, on the contrary, reached a peak in 2009 and remained high in 2010, 2011, and 2012 as investors flocked to relatively safer assets. As bond returns grew unusually high over the last few years, flows into bond funds may have increased as investors chased bond performance. Interestingly, outflows from U.S. stock funds continued despite U.S. large stocks showing positive returns since 2009. Was chasing bond performance the right thing for investors to do, or did investors just miss out on the returns of U.S. large stocks over the last couple of years?

About the data

U.S. Large Stocks—S&P 500® Index, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. International Stocks—Morgan Stanley Capital International (MSCI) World ex-U.S. Index. Bonds—20-year U.S. government bond. Annual Net Asset Fund Flows: U.S.-domiciled open-end fund flows from Morningstar. Start date of 1994 constrained by data availability. U.S. stock: funds that primarily invest in U.S. stocks; International stock: funds that invest in specific regions or a diversified mix of international stocks with 40% or more in foreign stocks; Bond: taxable bond funds (government, corporate, international, emerging markets, high yield, multisector) that invest primarily in fixed-income securities of varying maturities.

Fund Flows and Asset Class Performance 1994–2013



Past performance is no guarantee of future results. Assumes reinvestment of all income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. 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 are not guaranteed and have been more volatile than the other asset classes. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.

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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