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Investor Insights and Outlook

Don't Bet on a Correction

The US stock market has defied all but its most bullish friends. The S&P 500 is up 9.6% so far in 2012 and approximately 27% from its low of 1099 on October 3, 2011.

None of this has deterred those involved in the three main branches of bearishness. The first branch is the long-term bears, who still believe that the 2008 financial crisis changed everything.

These long-term bears think that the problems in Greece, and Europe, are just the continuation of the 2008 financial crisis. Some even blame the US for causing Europe's problems.

The long-term bears think economic problems have been papered over by government stimulus, Federal Reserve accommodation and the European bail-out. They fret that all of these economic mistakes cannot and will not cover up the crisis for much longer and that a relapse into crisis could occur.

The second branch of bearishness is a medium-term series of fears about a double-dip. These bears fret about high oil prices, inflation, deflation, weak consumer confidence, foreclosures, uncertainty about Obamacare, Dodd-Frank, the expiration of the Bush tax cuts, low interest rates, the labor force participation rate, and the list goes on and on. These bears think the economy is vulnerable to a relapse of weakness caused by just about anything.

The third branch is all about short-term trading. Many traders think the market has overdone it. They follow technical measures – valuation tools based on how far, how fast, how lopsided, how volatile a market has been. Many traders think the market is over-valued.

For example, traders will say that the market is over-valued and high oil prices will be the catalyst to knock the economy and markets back down. They are trying to back up their technical analysis with some

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Advisor Corner

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Six Reasons Why Boomers' Retirement is Different from their Parents

1. Much Longer Retirement: Many people in previous generations worked as long as they could and very few were fortunate enough to have a retirement that would be considered "golden" by today's standards. How many spent the last third (or more) of their lives pursuing hobbies and leisure instead of working? Boomers retiring in their 60s can expect to live about 30 years in retirement, which is a lot longer than their parents did.

2. Higher Expectations: Not considering tours of duty in Europe or the Pacific, how much traveling did past generations of retirees do? Boomers' parents were Depression-era babies who practiced frugality and continued to pinch pennies throughout retirement. In stark contrast, boomers want their retirement to include travel, vacation homes, new cars, dining out, etc. This is fine, but it is expensive. Therefore, boomers need to plan for a much more expensive retirement than their parents ever would have expected.

3. Personal Savings Instead of Pensions: The greatest generation might have had a lower per capita income but many also had corporate pensions. Boomers wanted higher salaries, freedom to change employers and the ability to save independently. Corporate pensions were largely phased out, giving way to the 401(k). However, when given the option, most boomers didn't start saving enough or early enough. Today, many boomers haven't amassed enough in personal savings, and most don't have meaningful pensions compared to their parents.

4. Rising Instead of Declining Interest Rates: In the 1980s, when the greatest generation started to retire, interest rates were much higher than they are today. The long decline in interest rates provided a great return to bond investors. The boomers are facing the very opposite situation. Instead of an ever-declining interest rate, they are facing the likelihood of steadily increasing interest rates during their retirement.

5. Exotic Investment Options: The greatest generation had relatively few investment options; mostly ordinary bonds and certificates of deposit. Today's boomers, on the other hand, are being offered an ever-expanding universe of income securities. The investment industry has provided a lot of rope, and a lot of new and exciting ways to lose it all.

6. Deregulations: If they felt like taking risk, the boomers' parents might buy some dividend paying stocks. At the time, most of the dividend paying industries, such as finance and utilities, were highly regulated. Decades of deregulation have caused these industries to become less predictable and more risky; hence, the certainty of previously assumed dividends is now extremely uncertain.

What Boomers Really Need: As boomers give up on stock gains, they tend to focus on income investing, and are always on the hunt for higher yields. There is no secret to finding higher yielding securities. In one way or the other, a higher yield just means higher risk: either term risk, credit risk or price risk. Higher-yielding securities always have more risk than lower yielding securities. And some high-yield securities can even be riskier than a simple basket of stocks, but with a lower expected return. For these reasons, you may want to ask your advisor to establish a sustainable withdrawal rate and build a diversified portfolio focusing on total return rather than focusing on dividend producing, interest-paying securities.

Diversification does not ensure a profit or protect against a loss in a declining market. The opinions herein are those of Morningstar, Inc. and should not be viewed as investment advice.

Assessing Risk

Investing and poker have been compared on many levels. For starters, poker is a zero-sum game — what the winner wins has to be equal to what the losers lose. But investing is not a zero-sum game because over time stocks tend to have positive returns, making it possible for investors to be overall winners.

Both, however, are games of incomplete information with unknown variables and conditions that cannot be controlled. To offset these uncertainties, it is important for players of both groups to assess and understand their appetite for risk. Doing so develops discipline, a strategy, and may help reduce unexpected setbacks.

The questions below are designed to help shed light on your risk tolerance. The questions are hypothetical in nature and are not meant to represent investment advice. Answers are symbolic of different risk levels: "a" conservative, "b" moderate, and "c" aggressive.

1. I am comfortable with investments that may often experience large declines in value if there is a potential for higher return.

    a. Disagree b. Uncertain c. Agree

2. Suppose you owned a well-diversified portfolio that fell by 20% over a short period of time. Assuming you have 10 years until you begin withdrawals from your account, how would you react?

    a. I would immediately change to a more conservative portfolio. b. I would wait at least 6 months to one year before changing to more conservative options. c. I would not change my portfolio.

3. Which statement best describes your investment goals?

    a. Protect the value of my account by minimizing loss and accepting lower long-term returns. b. Balance moderate levels of risk with moderate levels of returns. c. Maximize long term returns and accept large or dramatic swings in the value of my investments.

4. Portfolios with the highest average returns also tend to have the highest chance of short-term losses. The data below represents five hypothetical investments of $100,000 over a one year time frame. Which range would you feel most comfortable with?

    a. Portfolio A: $139,000 – $88,800 b. Portfolio B: $179,000 – $75,700 c. Portfolio C: $215,000 – $59,500

Now, keep in mind that these are only guidelines meant to give you insight into how you think and behave as an investor. Once you have discovered that you are, let's say, aggressive, this certainly doesn't mean that you now have to invest in high risk stocks and emerging markets for the rest of your life. On the contrary, your risk tolerance may change over time, and revisiting these questions periodically may let you know if it's time to change your investment strategy.

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results.

Don’t Count on a Correction (continued)

fundamental fear. (*continued on back)*

Our advice to investors is that they should ignore all this talk about a correction. Last August and September is the perfect example. The stock market was getting slammed. All three branches of the bears were standing on their hind legs, growling loudly and beating their chests. Short-sellers made tremendous profits.

But then the stock market turned around on a dime when no one expected it to. Even though the bears have remained bears, the market had a huge October and then continued on it merry way to new post-crisis highs. Investors who sold in August or September have paid a huge price.

There may be a trader who can capture all of this, but in the end, the history of America is clear. Bears make money every once in a while, but it’s the long-term bulls, who believe in the steady progress of technology and wealth creation, that make money most consistently.

Adapted from an article of the same title written by Brian S. Wesbury, Robert Stein, and Strider Elass of First Trust Advisors L.P.

Investing in I-Bonds

When investors think about adding inflation protection to their portfolios, Treasury Inflation-Protected Securities (TIPS) are usually the top pick. But investors looking to add inflation protection have another option: I-Bonds. I-Bonds are Treasury bonds that pay a fixed rate of interest as well as another layer of interest that varies with the current inflation rate, as measured by the Consumer Price Index. I-Bonds are available only to individuals, with face values as low as $25. I-Bonds reach their final maturity 30 years after issuance, but investors can cash them in 12 months after purchase. If you redeem an I-Bond within five years of buying it, however, you'll forfeit three months' worth of interest. I-Bonds don't pay you income while you own the bond. Rather, the interest accrues and gets paid out when you sell or the bond matures. Because I-Bonds don't make regular interest payments, holders don’t pay any taxes until they sell or the bond matures.

Therefore, if you plan to buy and hold an I-Bond for many years, it's fine to do so within a taxable account. This means you won't owe taxes on the accrued interest until you no longer own the bond. When you receive income from I-Bonds after they mature or you sell, you will owe federal tax but not state or local taxes. I-Bond proceeds to pay for college expenses are exempt from federal tax, assuming they (and their expenses) meet certain criteria. Because I-Bonds already come with an element of tax deferral, you cannot hold them inside an IRA. I-Bond purchases are currently restricted to just $10,000 per year. Because I-Bonds don't make regular interest payments but instead generate income when you sell, they're not a good option for those looking to fund living expenses with the current interest from the bonds. Because of their tax advantages, I-Bonds may be worth considering for investors' taxable accounts and can be held in conjunction with any TIPS holdings in a tax-deferred account.

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