Investor Insights and Outlook

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Bond Market Math

- **Since hitting multi-generational lows, interest rates (and bond yields) have spiked significantly higher.**
- **Bond prices and yields move in opposite directions. Therefore, a 1% increase in yield would equal a more significant decline in the value of bonds with longer dated maturities.**
- **We don't believe that you should bail on bonds just yet, no matter how tempting it may be.**

In recent years, central banks have kept interest rates low in an effort to support the struggling global economy. Despite the low rates, risk-averse investors have flocked to high-quality government bonds, largely to avoid the effects of the slow economy. The combination of central bank action and the economics of supply and demand have caused bond prices to rise. However, Federal Reserve (Fed) Chairman Bernanke recently brought up the possibility of tapering stimulus activity (slowing the pace of asset purchases by the Fed). The mere mention of tapering caused interest rates and bond yields to spike. Conversely, because bond yields and prices move in opposite directions, the value of bonds fell precipitously.

Exhibit 1: Yields Rise, Prices Fall

Source: SEI
Calculations are for hypothetical bonds with $1,000 face value, various maturities and a $35 annual coupon paid once per year assuming a 1% change in yields.

Opposites Don't Attract

A rise in yields corresponds to a much larger decline in value for longer-dated bonds, as seen in the hypothetical Exhibit 1 (above).

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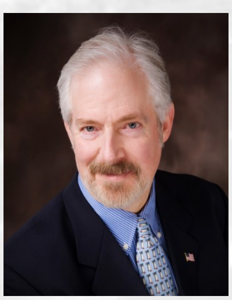

Advisor Corner

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Stupid Stock Market Tricks:
Looking for Guidance in All the Wrong Places

As millions of people around the world watched Super Bowl XLVII in February, at least some were concerned more about how the outcome would affect their portfolios than the game itself.

According to the Super Bowl Indicator (SBI) theory, the winning team indicates the fate of the stock market for the rest of the year.

The theory holds that if a team from the former American Football League (like the Baltimore Ravens) wins, the outlook for stocks is bearish. On the other hand, a win by an original National Football League team (like the San Francisco 49ers) indicates that the market will go up that year. The SBI has been remarkably accurate, correctly predicting the annual direction of the stock market about 75% of the time.

If you believe the SBI theory, we should not expect a great 2013 for the stock market.

And if you follow financial news closely, you know that Wall Street is awash in theories on the performance of the stock market and the economy. Most of them sound plausible enough, based on expert analysis of data or superior research.

There are also a number of downright bizarre theories.

For example, if the NY Mets reach the World Series (only 4 times in the last 5 decades), the market is supposed to experience a serious decline. Adherents of this theory can only hope the team doesn't do well each year.

It's also supposed to be a bad sign for investors if a horse wins racing's famed Triple Crown. This has happened on ly 10 times in almost 100 years, and not since 1978. However, if there is a Triple Crown winner, don't despair completely, the market enjoyed positive returns 8 out of 10 times the year following a Triple Crown victory, returning an average of 8.9%

Whether it is horseracing or football, the central problem with all these theories is a confusion of correlation with causation.

Just because two variables move together, does not mean that one is influencing the other. If you mine data deeply enough, it is easy to find completely disparate variables that seem to react in similar directions. This is sometimes

known as the Texas sharpshooter fallacy, a logical fallacy in which unrelated data is interpreted (or manipulated) to seem meaningful. The expression comes from the story about a Texan who fires his rifle several times at the side of a barn, then draws a bull's eye around the hits and proclaims himself a sharpshooter.

A classic example of the Texas sharpshooter fallacy is the belief that if the Washington Redskins lose their last home game prior to the election, the incumbent party will lose the White House. This theory has worked in 20 of the last 21 elections—it failed in 2012 when the Redskins lost their last home game but the incumbent party kept the White House.

Rationally, we know that football and elections (or football and markets) have nothing in common. But theories like this have an almost seductive hold on us, in part our brains are hard wired to make mental shortcuts. Often referred to as "heuristics," these are largely rational rules, coded by evolution, which help us make decisions and solve problems. These rules work fairly well under most circumstances, but in some cases they can lead us to make serious mistakes due to cognitive biases—or distortions in the way we perceive reality. For example, we tend to think that trends will continue. Applied to stock markets, this can lead investors to believe that a rising market will keep rising...and that is how booms become bubbles.

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Living in Retirement: A Three-Phased Approach

Although many Americans now plan for a retirement up to 20 years, your retirement may last much longer.

Traditionally, retirees were advised to project income needs over the length of time of retirement, add on an annual adjustment for inflation, and then identify any potential income shortfall. But the planning required may not be that linear. For example, research suggests that some retirees' expenses -- other than health care -- may slowly decrease over time. That means many retirees -- depending on personal expenses -- may need more income early in their retirement than later. This necessitates taking a fresh look at retiree expenses and income, as well as withdrawal and estate planning strategies.

Phase 1: The Early Years

The need to potentially stretch out income over a longer period than previous generations also means that some people may not want to tap Social Security when they're first eligible. Consider that for each year you delay taking Social Security beyond your full retirement age until age 70, you'll receive a benefit increase of 6% to 8%, depending on your age. One caveat: If you do decide to delay collecting Social Security, you may want to sign up for Medicare at age 65 to avoid possibly paying more for medical insurance later.

Also plan ahead as to how you'll pay for health care costs not covered by Medicare as you age. Remember that Medicare does not pay for ongoing long-term care or assisted living and that qualifying for Medicaid requires spending down your assets.

If you have accumulated assets in qualified employer-sponsored retirement plans, now may be the time to decide whether to roll that money into a tax-deferred IRA, which could make managing your investments easier. A tax and financial professional can also help you decide which accounts to tap first at this point in your post-retirement planning -- a situation that could significantly affect your financial situation.

Finally, don't overlook any pension assets in which you may be vested, especially if you changed employers over the course of your career. Pensions can supply you with regular income for life.

Phase 2: The Middle Years

By April 1 of the year after you reach age 70½, you'll generally be required to begin making annual withdrawals from traditional IRAs and employer-sponsored retirement plans (except for assets in a current employer's retirement plan if you're still working and do not own more than 5% of the business). The penalty for not taking your required minimum distribution (RMD) can be steep: 50% of what you should have withdrawn. Withdrawals from Roth IRAs, however, are not required during the owner's lifetime. If money is not needed for income and efficient wealth transfer is a goal, a Roth IRA may be an attractive option.

Also, consider reviewing the asset allocation of your investment portfolio. Does it have enough growth potential to keep up with inflation? Is it adequately diversified among different types of stocks and income-generating securities?

Phase 3: The Later Years

Review your financial documents to make sure they are true to your wishes and that beneficiaries are consistent. Usually, these documents include a will and paperwork governing brokerage accounts, IRAs, annuities, pensions, and in some cases, trusts. Many people also draft a durable power of attorney (someone who will manage your finances if you're not able) and a living will (which names a person to make medical decisions on your behalf if you're incapacitated).

You'll still need to stay on top of your investments. For example, an annual portfolio and asset allocation review are important.. Keep in mind that a financial advisor may be able to set up an automatic rebalancing program for you. And finally, be aware that some financial companies require that you begin taking distributions from annuities once you reach age 85.

Preparing for a retirement that could encompass a third of your life span can be challenging. Regularly review your situation with financial and tax professionals and be prepared to make adjustments.

Bond Market Math, continued from pg. 1

What Does This Mean for Bond Funds?

What is most important to investors is how rising interest rates will impact the funds that they own. Given that some bond funds have higher yields (generating additional income to help offset the price declines) and shorter maturities (to help mute the price declines) than their benchmarks, we would generally expect these funds to modestly outperform their respective indices in an environment where interest rates are rising. This is not to say that bond funds won't decline in value, but rather that the magnitude of the decline should be less than the level of decline in the benchmark.

When faced with any declines at all, some investors will likely wonder why they should hold bonds at all. This is especially true in the environments like the current one, where we have witnessed negative short-term returns and face the prospect of low or negative returns for the rest of this year. While bond returns could be meager, the decision of whether or not to hold them should be based on an investor's objectives, not on short-term market expectations. Fixed income investment strategies can and do play a role in a variety of investment strategies and will continue to do so, regardless of which direction interest rates move. We believe that fixed-income markets continue to offer attractive income-producing opportunities, while Treasury securities may provide an appealing hedge to more aggressive portions of investors' portfolios. Furthermore, diversification is as simple as it is powerful. While diversification may not protect against market risk, spreading a portfolio among a variety of investments can result in a more consistent pattern of returns and income.

Stupid Stock Market Tricks, cont. from pg. 2

Conversely, when markets are falling and the economy is in trouble, it is hard to believe that the stock market will ever go up again.

We also have a heuristic for spotting patterns, which is very helpful in drawing meaning out of the noise and confusion of life. But this can shade over into what psychologists call "the clustering illusion" or seeing patterns where actually none exist.

Life is chaotic and uncertain, and investing is no different. You can flip a coin a thousand times and potentially get tails every time. That's the problem with randomness—it can sometimes appear meaningful. From football to elections, we yearn for signs and directions that will make the markets seem just a little more orderly and predictable. Most of us are smart enough to shun the more obviously implausible theories.

Markets may be chaotic and unpredictable over the short term, but in the long term they are remarkably efficient. It is much more prudent to invest for the long term, allocate your portfolio prudently and stay the course.

(Thank you to J. William G. Chettle, Chief Marketing Officer, Loring Ward, for his insights in this article.)

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