Investor Insights & Outlook

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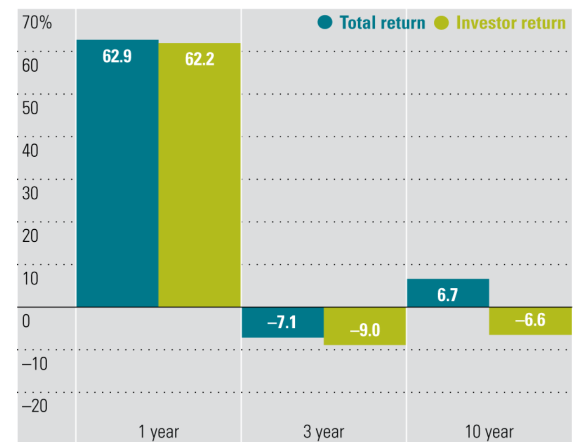
Chasing Performance

Investors often endure poor timing and planning as many chase past performance. They buy into funds that are performing well and initiate a selling spree following a decline. This becomes evident when evaluating a fund's total return compared with the investor return. Overall, the investor return translates to the average investor's experience as measured by the timing decisions of all investors in the fund.

The image illustrates the investor return relative to the total return for a given fund. Over the short term, both the total and investor returns were positive, with the investor return ending slightly lower. Over a 10-year period, however, total return greatly exceeded investor return. Investors who attempted to time the market ran the risk of missing periods of exceptional returns.

Comparison of a Fund's Return Performance Over Time



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Returns and principal invested in stocks are not guaranteed. Morningstar investor returns measure how the typical investor in that fund fared over time, incorporating the impact of cash inflows and outflows from purchases and sales. It is not one specific investor's experience, but rather a measure of the return earned collectively by all the investors in the fund. Total return measures the percentage change in price for a fund, assuming the investor buys and holds the fund over the time period, reinvests distributions, and does not make any additional purchases or sales. Investor returns are not a substitute for total returns but can be used in combination with them. Data as of February 2010.

Source: The fund illustrated in this example was selected from Morningstar's open-end database.

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Advisor Corner

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Economics and Recovery

ASK JIM:

- How might the recent events and current economics impact my financial plan?

The market has had its ups and downs in March, but the overall atmosphere has been optimistic in light of less negative news from Japan and the Middle East. On the non-so-optimistic side, however, bad news on the European debt crisis (Portugal in particular) may signal some dark clouds looming ahead.

Employment: After a year of almost no progress, employment statistics have finally begun to show some improvement. Current unemployment claims are in the 300,000 to 350,000 range, approximately half of the 674,000 we've seen in the early months of 2009. Since 20%-25% of the jobs lost during the recession were in the construction sector, significant improvement in unemployment numbers may not occur until both the homebuilding and construction industries recover. Still, in light of these recent positive numbers, next week's jobs report is an eagerly awaited piece of news.

Consumer spending: Other statistics to be released next week include personal income and spending data for the first quarter of 2011, which may provide insight into whether consumer confidence is back or still waning. Consumption numbers are crucial data points for quarterly GDP forecasts, which for now appear to be in the 2.0%-4.0% range. With higher inflation rates and volatile import numbers, Morningstar analysts estimate that first-quarter GDP growth may be on the lower side of this range. However, companies will start reporting corporate earnings next month, significantly impacting the market and economic forecasts.

Tech sector: Excellent news from the tech sector fueled the market in recent weeks, with some technology companies reporting revenue growth as high as 25% and raising their dividends. In the improving economic environment, businesses now have more money to invest in new technologies, such as cloud computing, which in turn may fuel future growth.

Housing market: Unfortunately, housing data still does not indicate any significant improvement. New and existing home sales in February were dismal; only 250,000 units were sold, a new record low dating back to the 1960s. This is in sharp contradiction with realtors' and builders' optimism about the spring selling season. Even when taking seasonal factors into account, such as bad weather and low temperatures, the outlook remains bleak.

Economic growth: The GDP number for the fourth quarter of 2010 has been revised for a third and final time, from 3.3% to 2.8% and now back to 3.1%. Increasing consumer confidence was reflected in strong spending on consumer durables, with modest growth in non-durable goods and consumer services displaying the smallest growth. The overall message is clear: consumers are back, increasingly confident and willing to spend.

The tale of two recoveries (rich versus not so rich): As worrisome as this new may be, it is by now clear that so far in the recovery higher earners have fared much better than their counterparts (especially those with less education). The latter continue to face double-digit unemployment and have difficulties confronting the higher food and energy costs. Further pain in the lower income brackets may create a ripple effect and stall overall economic growth.

Quarter-end insights: Although this year started on a bad note, Morningstar economists are optimistic and predict that real GDP growth of 3.5%-4.0% may still be possible if inflation doesn't get out of control. However, this is a big "if." Judging by the already-rising fuel and food prices, inflation may reach 3% in no time (the annualized increase in the Consumer Price Index over the last six months is an even more frightening 3.9%). Looking forward, consumer spending remains key, as well as business investing. These may well be the two most important determinants of the recovery for the rest of the year.

The Many Faces of Inflation

DID YOU KNOW?

- Teh government measures the nationwide change in price of 95,000 goods and services to calculate the Consumer Price Index (CPI)?

During the recent 2007–2009 recession, it seems all we've seen and heard about the economy was bad news: the housing market collapsing, 401(k)s suddenly being worth much less than before, a lifetime of savings almost disappearing in a few months, rising unemployment, and fluctuating prices. Now that the recession has officially ended in June 2009 and we're on the road to recovery, inflation may become a concern once again. In this uncertain economic climate, it may be helpful to learn about the different types of inflation and their immediate effects.

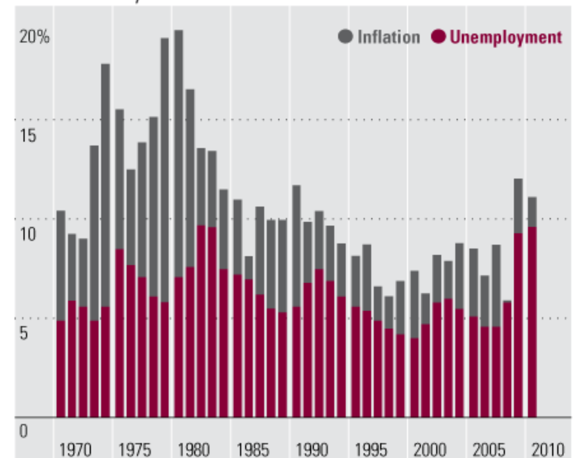
Inflation: Inflation is defined as a continuing rise in the general prices of goods and services. Simply put, if prices, on average, are going up in an economy, then you've got inflation. With a set amount of money in an inflationary environment, consumers are able to buy less and less over time. High rates of inflation can generate uncertainty, lower productivity and discourage investment. The leading measure of inflation in the United States is the Consumer Price Index (CPI). The government can change its monetary policy to control the money supply and keep inflation in check, although this is not the only variable affecting inflation. In November 2010, the Federal Reserve announced it would buy back long-term Treasuries in order to inject money into the economy, a policy called quantitative easing, which can trigger higher inflation.

Hyperinflation: Hyperinflation is extremely high, out of control inflation, caused by a steep increase in the money supply without a corresponding increase in the output of goods and services. Well-known examples include the German hyperinflation after World War I and the hyperinflation in Hungary after World War II. It appears that such an extreme phenomenon occurs mainly as a result of radical changes and prolonged economic instability.

Deflation: Deflation is the opposite case: a general decline in the prices of goods and services. In the U.S., deflation occurred as recently as 2008 and 2009: The change in CPI was negative in the third and fourth quarters of 2008 and in the fourth quarter of 2009, a clear indicator of deflation. The obvious positive effect here is lower prices—many argue that deflationary periods are good times to buy. The problem with deflation, though, is that consumers reduce spending and businesses stop growing, which is not good for the economy.

Stagflation: This is the worst-case scenario: high inflation and slow growth simultaneously. Normally, there is an inverse relationship between inflation and unemployment; if the economy is able to tolerate a higher rate of inflation, lower unemployment can be achieved, and vice versa. But during a stagflation period, both inflation and unemployment go up. An interesting measure for stagflation is the misery index, which, as illustrated in the image, combines the unemployment and inflation rates. The U.S. experienced severe stagflation in the 1970s, when unemployment and inflation reached a combined high of almost 20%. There has been talk of stagflation during the recent crisis as well, but the potentially encouraging news is that the misery index is not nearly as high now as it has been in the past.

The Misery Index



Source: Inflation is represented by the Consumer Price Index, and unemployment by the national unemployment rate, not seasonally adjusted, from the Bureau of Labor Statistics.

Four Steps to Debt Reduction

Easy access to credit can contribute to a lifestyle that starts out with debt and gets worse as spending pressures increase. If you've accumulated debt, how can you dig yourself out?

Calculate Exactly What You Owe: List your debts and minimum monthly payments, due dates and interest rates. Rank debts from highest rate to lowest. Decide if any debt is worth keeping. Consider mortgages and college loans since interest on most mortgages is tax deductible and many college loan rates are reasonable.

Set Up a Budget and Start Eliminating Your Debt: A budget helps you decide how much extra cash you can devote to paying debt. It also helps you identify expenses that you can cut back on, which leads to more cash to further reduce your debt.

Lower Your Borrowing Costs: Compare what rates credit card firms are offering. Then get your current credit card company to match the attractive rate you discover. Or, transfer your current higher interest-rate balance to a company offering a lower rate. However, make sure you find out how long this lower rate will last and what the regular ongoing rate will be. Also, be on the lookout for balance transfer fees.

Cash Is King: Try to stick to cash and/or use a debit card. Unless you have developed a disciplined approach to pay off the balance, do all you can to avoid using a credit card. Find one card with a low rate for situations that may require one, like Internet purchases, but be sure to pay it off every month.

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