Investor Insights and Outlook

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The Art of Asset Location

Asset location is a part of the investing strategy that involves deciding which investments to hold in which accounts, and taxes play an important role in this decision. Here are a few basic guidelines.

Hold in Your Tax-Sheltered Accounts: Assets With High Tax Costs. In general, government or corporate bonds and bond funds may be a better fit for tax-sheltered accounts (like IRAs and 401(k)s) than for taxable accounts because their payouts are taxed at an investor's ordinary income tax rate. If you need to hold bonds in your taxable accounts, a municipal bond or municipal bond fund might offer you a better after-tax yield than a taxable bond investment, because income from munis is exempt of federal income taxes.

Hold in Your Taxable Accounts: Assets With Low Tax Costs. By contrast, stocks and stock funds may generally be a better bet for taxable accounts. Long-term capital gains, which is what you have when you sell a stock that you've held for at least a year, are taxed at a much lower rate than bond income (however, these favorable tax rates are set to expire at the end of 2012).

Stocks are not guaranteed and have been more volatile than the other asset classes. Dividends are not guaranteed. Bonds are subject to credit/default risk and interest-rate risk. Municipal bonds may be subject to the alternative minimum tax (AMT) and state and local taxes, and federal taxes apply to any capital gains distributions. Retirement accounts are tax-deferred vehicles designed for retirement savings. Any withdrawals of earnings will be subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal tax penalty. This should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

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Advisor Corner

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Know Your Own Inflation Rate

The Consumer Price Index (CPI), a measure of inflation, is a monthly statistic representing the change in prices paid by urban consumers for a representative basket of goods and services. While this measure serves more as an official gauge, a lot of consumers (especially retired consumers and investors) seem to have a different sense of inflation. The question often arises: Why is it that the official rate seems to be lower than what we're actually feeling out there?

Our inflation rate may vary depending on our individual expenditures. This means that some people may experience higher inflation relative to others. For a senior, food and energy costs are a very high proportion of their total household outlay. The location where you live can also impact your personal inflation rate. If you have a fixed-rate mortgage, or if you're retired and your home is paid for, you won't experience fluctuating housing costs as a result of having an adjustable-rate mortgage or paying rent. But you may see housing costs vary from one region of the country to another. Another big swing factor in your personal inflation rate is health-care cost. If you have purchased a long-term care policy with an inflation rider, you can insulate yourself against rising nursing home and other long-term care costs.

Anyone who has Social Security has a buffer against higher prices because Social Security includes a cost-of -living adjustment. If a Social Security paycheck is a big proportion of your total income needs, you're likely in good shape as far as inflation is concerned. If it's just a tiny portion of your total income needs, you're not in as good a shape. If you're receiving a pension with an inflation adjustment it can help you stave off inflation, and the same goes for folks who have an annuity with an inflation rider; they will have some protection against inflation. What about folks who are still in employment? If you're still working, either fulltime or part-time, you may potentially be able to get a cost-of-living adjustment in your paycheck. If you're not working and not eligible for those cost-of-living adjustments, you'll need to plan for inflation accordingly.

Finally, it's also important to gauge whether your portfolio is built to withstand your personal rate of inflation. Portfolio composition is the key here. Investments such as short-term bonds and cash may not safeguard against the threat of inflation. If a high proportion of your portfolio consists of cash or short-term bonds without any inflation protection built in, you may see a large percentage of your return eaten away by inflation. Next up is your portfolio time horizon. Seniors who are quite far into their retirement and don't anticipate having a long time horizon for their investment assets probably need to be less concerned about the toll that inflation will take over time. However, if you're just starting out in retirement, you may need to plan for inflation-proofing your portfolio, because over time, even a seemingly benign inflation rate of 3% may take a bite out of your portfolio return.

Diversification does not eliminate the risk of experiencing investment losses. Government bonds and Treasury bills are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than other asset classes. Annuities are suitable for long-term investing, particularly retirement savings. Annuity risks include market risk, liquidity risk, annuitization risk, tax risk, estate risk, interest-rate risk, inflation risk, death and survivorship risk, and company failure risk. Withdrawal of earnings will be subject to ordinary income tax and, if taken prior to age 59½, may be subject to a 10% federal tax penalty. Additional fees and investment restrictions may apply for living-benefit options. Violating the terms and conditions of the annuity contract may void guarantees. Consult a financial advisor and tax advisor before purchasing an annuity.

Should You Refinance Your Mortgage?

In an uncertain market and economic environment, it pays to take advantage of all the sure things you can get. A prime example is paying down any debt you have, even mortgages and other loans that some might classify as "good debt" because they carry relatively low interest rates and may offer tax deductions. By chipping away at your borrowing costs, you'll reduce the interest you owe over the life of your loan. With that being said, it's a good time to investigate whether it benefits you to refinance your mortgage. In an effort to jump-start the moribund economy and jumbo loans threshold housing markets, the Federal Reserve aggressively cut interest rates in 2008, which has brought both 15- and 30-year mortgage loans in the vicinity of 5%, a historically low level. In 2009 and in 2010 so far, the rates have remained low.

You should consider refinancing if one or more of the following applies to you:

• Your current interest rate is appreciably higher than prevailing rates. There are a number of nifty calculators on various websites to help you determine this (www.bankrate.com is a good one).

• You plan to stay in your home for several or many more years, thereby increasing the likelihood that you'll recoup your closing costs over the life of the loan.

• You have an adjustable-rate mortgage with a currently low interest rate but plan to stay in your home for several more years and would like to lock in a relatively low fixed rate.

• You would like to switch to a shorter-term mortgage with a lower interest rate—say, you have a 30-year loan and would like to swap into a 20-year loan. Just be sure your job is rock-solid before increasing your monthly debt. If you're concerned about job security, you can still refinance but instead stick with the same term and make additional payments on principal.

• You have a jumbo, or "nonconforming," loan that may no longer be considered jumbo. The threshold for jumbo loans is $417,000, but in certain high-cost parts of the country the thresholds are now higher. Jumbo loans usually carry higher rates than do non-jumbo loans, so if you can do away with that categorization, you'll be in a better position. Even if your loan still lands in jumbo territory, you may be able to secure a lower rate.

• You have great credit—650 or ideally even higher—and you haven't lost your job or missed a mortgage payment since you secured the loan.

• You have a decent amount of equity in your home—ideally 20% or more. However, you may still be able to refinance if your home is now worth about the same as your loan value or even a little bit less; check out http://makinghomeaffordable.gov for details about refinancing for those whose loans are now 105% or less of their property values.

• You have the cash on hand to cover the closing costs up front. The 2009 Closing Costs survey conducted by bankrate.com put the average home loan's closing costs at $2,732. By fronting the closing costs, you're likely to be able to obtain a more favorable loan rate.

After reading the above characteristics, you can determine when refinancing might not make sense (if you already have a low rate, won't be able to recoup your closing costs, etc.). In addition to those that are fairly clear-cut, you should also keep in mind that your property will need to be reassessed as part of the refinancing process. This might force you to have to pay private mortgage insurance. Lenders assess PMI when a loan is more than 80% of the current value of the home. Finally, you might have had a mortgage for many years and are seriously chipping away at the principal. If that's the case, refinancing, and thereby extending the term of the loan, could increase the total interest you'll pay, even if you're able to reduce your monthly payment.

The Flavors of Investing

It is tempting to jump on the investment bandwagon when certain parts of the market soar based on a trend or analyst report. While great potential exists, sector investing can also come with great risk.

As seen in the image, what is hot one year isn't always hot the next. Interested investors should be willing to follow a sector's ups and downs, as timing the market is difficult. Investing in specific sectors can add volatility to a portfolio, but exposure to the right sectors can contribute to improved financial performance. Keep in mind that while sector investing can fill a gap or serve as a speculative play, a balanced asset allocation should be the core of any portfolio.

10-Year Sector Winners and Losers

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Highest return	4.3	50.3	38.1	40.8	39.4	32.9	−16.1	61.9	30.5	18.5
	−6.3	41.0	32.1	14.8	36.2	27.5	−23.3	53.6	27.4	13.4
	−6.6	37.6	23.3	12.2	21.8	17.2	−28.1	50.2	24.9	11.9
	−9.1	37.3	19.2	8.1	19.7	16.6	−38.2	35.6	24.2	6.9
	−13.1	34.8	17.9	6.0	17.6	12.6	−38.4	34.0	23.4	5.1
	−21.1	32.1	15.4	6.0	15.4	12.0	−39.4	29.3	23.2	4.1
	−23.6	26.1	14.4	5.2	15.1	8.0	−39.8	24.0	14.5	0.6
	−23.8	24.7	12.5	3.7	15.0	0.2	−41.2	21.0	13.4	−0.4
	−23.8	19.8	10.1	3.0	11.9	−8.7	−42.0	15.6	11.8	−0.7
	−37.3	18.9	3.5	−1.4	10.9	−17.9	−48.1	14.5	7.3	−14.1
Lowest return	−38.3	17.4	0.8	−6.0	6.7	−18.3	−51.3	11.8	5.1	−16.5

Basic Mat.
Comm. Ser.
Cons. Cyclical
Cons. Def.
Energy
Financial
Health Care
Industrials
Real Estate
Technology
Utilities

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. Sector investments are narrowly-focused investments that typically exhibit higher volatility than the market in general. Sector investments will fluctuate with current market conditions and may be worth more or less than the original cost upon liquidation. Returns and principal invested in stocks are not guaranteed.

Source: Sectors in this example are represented by the Morningstar Sector Indexes.

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