Investor Insights & Outlook

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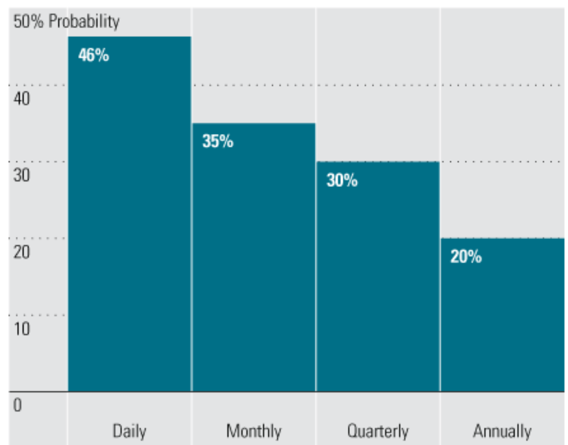
Short-Term Focus: Coping with Near-Term Fluctuations

Instant access to real-time quotes and media reports can make it difficult for investors with a long-term investment horizon to stay focused on their goals. In reality, these daily market movements may not be as extreme as they seem. As investors look longer term, their perception often changes. Short-term market fluctuations can be quite volatile, and the probability of realizing a loss within any given day is high. However, the likelihood of realizing a loss has historically decreased over longer holding periods. The image illustrates that while the probability of losing money on a daily basis over the past 20 years was 46%, the probability dropped dramatically when analyzing an annual time period—20%. Periodic review of an investment portfolio is necessary, but investors shouldn't let short-term swings affect their view of the future.

Probability of losing money in the market 1991–2010



Source: Stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. An investment cannot be made directly in an index. Returns and principal invested in stocks are not guaranteed. Probability of loss is calculated as the number of negative periods divided by the number of total periods using the specified frequency of data.

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What Is an Economic Moat?

Historical data shows that stocks might be the best investment to help you build wealth over time. However, with so many stocks available out there, how do you decide which one to pick? What makes a stock a good or a bad investment? The answer lies in carefully scrutinizing the company.

A company's stock is likely to generate attractive returns if the company outperforms its competitors. The advantage a company builds over its rivals in the marketplace is called competitive advantage. Morningstar has developed a rating to measure this competitive advantage, the "economic moat." There are four main types of economic moats, examined below.

1. Intangible assets: Intangible assets like brands, patents, and regulatory licenses can provide a company with a unique position in the marketplace and a significant advantage over its competitors. A powerful brand like Apple or Nike can bring in more revenue and increase customer retention. Patents are especially important for technology companies and companies in industries where innovation is critical (pharmaceuticals, for example). Regulatory licenses provide a competitive edge in the sense that they can prevent competitors from entering a market.

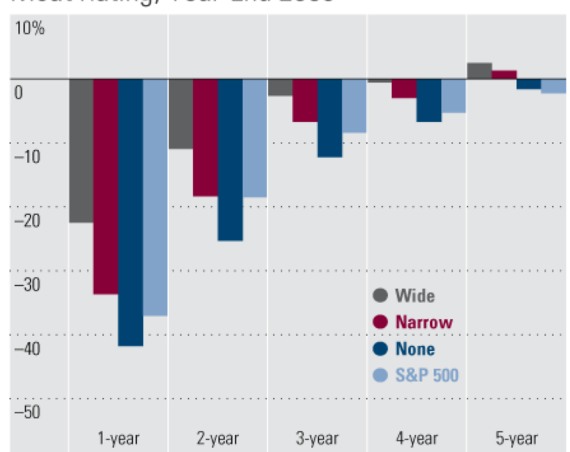
2. High customer switching costs: Basically, if a company makes it difficult (and, ideally, impossible!) for customers to switch to a competitor, that company will have a much easier time growing revenues and expanding. Examples of industries with high switching costs include banks and software companies.

3. The network effect: The network effect is based on the simple premise that the more users a product or service has, the higher its value will be. The most popular example of this type of moat is Microsoft: its success is highly dependent on its enormous user base. In fact, this network effect occurs mainly in businesses based on sharing information and connecting people (eBay is a good example).

4. Cost advantages: This type of competitive advantage is probably the simplest, and yet the most difficult to achieve. Companies can build a cost-based economic moat by improving their business processes (Dell and Southwest Airlines), optimizing their supply chains (Wal-Mart), or by outsourcing in order to reduce labor costs ("made in China," anyone?). Cost-cutting can be a two-edged sword, however, and, once the competitive advantage is achieved, it may prove difficult to maintain.

In Morningstar's database, stocks are assigned an economic moat rating: wide (denoting a strong competitive advantage), narrow (weaker), or none (no competitive advantage). The image shows that wide-moat stocks have outperformed narrow- and no-moat stocks, as well as the S&P 500 index, over the five time periods analyzed.

Total Return by Morningstar Economic Moat Rating, Year-End 2008



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. Returns and principal invested in stocks are not guaranteed. References to specific securities should not be considered an offer (as defined by the Securities and Exchange Act) to purchase or sell such securities.

Source: Wide-, narrow- and no-moat stocks from Morningstar. The S&P 500® index is an unmanaged group of securities and considered to be representative of the stock market in general.

The Price of Education

While it is often stated that a college education is priceless, the reality is that costs continue to rise each year. The good news is that many sources of financial aid are available to students and their families. For example, during the 2010–2011 academic year, $227.2 billion in financial aid was distributed to undergraduate and graduate students in the form of grants from all different sources (see footnote). Moreover, there are plenty of savings vehicles that can be utilized.

The table illustrates the trends in college pricing for the 2011–2012 academic year, according to the College Board's Trends in College Pricing. When compared with the prior year, the various fees are up at least 4.4%, with a high of 8.3% (tuition and fees only). It appears that the rate of growth in tuition and fees has been more rapid at public four-year institutions than at private four-year institutions.

These costs might seem somewhat alarming to most people (especially to those parents who have put off saving and planning for their children's college). But about 44% of students who are enrolled at four-year colleges or universities attend institutions that charge tuition and fees of less than $9,000 per year. When taking into account only public four-year colleges and universities, this number climbs to 61%. While private four-year institutions have a much wider range of tuition and fee charges, only about 11% of all students attended colleges (public and private) with tuition and fees totaling $33,000 or higher per year.

In any case, it would be wise for parents to start saving for college as soon as possible and to assume children will attend a private four-year institution (assume "the worst"). If they receive grants and/or scholarships or decide to opt for a more affordable option, think of all the fun things you can do with the excess cash! There is an array of college-savings options available, and many offer tax-deferred growth and tax-free withdrawals (when used for qualified higher-education expenses). Some of the more popular plans include 529 plans and Coverdell Education Savings Accounts (ESA). There are contribution limits to the various plans, and plenty from which to choose, so it would be wise to consult with your financial advisor to see what is right for you.

As with any goal, whether you are saving for retirement or a vacation home, the key is to start saving early (don't wait until your child is born), and save often. While it's easy to procrastinate when it comes to initiating a long-term college savings plan, the sooner you begin, the more likely it is that the plan will succeed. By starting early, you are taking advantage of the power of compounding and, in this case, time can be your best friend.

Trends in College Pricing: 2011–2012 Academic Year

Type of college/ university	Tuition & fees	% change vs. prior year	Including room & board	% change vs. prior year
Public 4-year (in-state student)	$8,244	8.3%	$17,131	6.0%
Public 4-year (out-of-state student)	$20,770	5.7%	$29,657	5.2%
Private 4-year (nonprofit)	$28,500	4.5%	$38,589	4.4%

Source: College Board's Trends in College Pricing, 2011.

[1] College Board's Trends in Student Aid, 2011.

Tax-friendly States for Retirees

Federal taxes are the same wherever you choose to retire; however, state and local taxes add up depending on the state you pick to spend your retirement years. Taxes may apply to your retirement/pension income, purchases, real estate and social security benefits.

Taxes on individual and pension income differ from state to state. Seven states in the U.S. (Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming) currently do not tax individual income. On the other hand, California, District of Columbia, Hawaii, Iowa, Maine, New Jersey, New York, Oregon, and Vermont tax retirement income at a rate of 8% or higher. Pennsylvania and Mississippi exempt pension income completely, while states like Michigan and Maine exempt only a portion of pension income. If you estimate receiving considerable income in retirement, state income taxes could play a significant role in what you get to keep.

In addition to state taxes on retirement and pension income, retirees also need to look at sales tax charged on items they purchase. Sales tax varies from state to state with some states charging sales tax as high as 7%, while others adopt a "no sales tax" policy. Alaska, Delaware, Montana, New Hampshire, and Oregon have no state sales tax, while California has the highest sales tax rate of 8.25%. Retirees who rely only on a fixed source of income in retirement should also carefully consider property taxes and estate taxes when estimating their tax liabilities.

Source: 2011 CCH Whole Ball of Tax. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment, tax, or legal advice. The information provided is as of October 2011. Please consult with your financial professional regarding such services.

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