Investor Insights & Outlook

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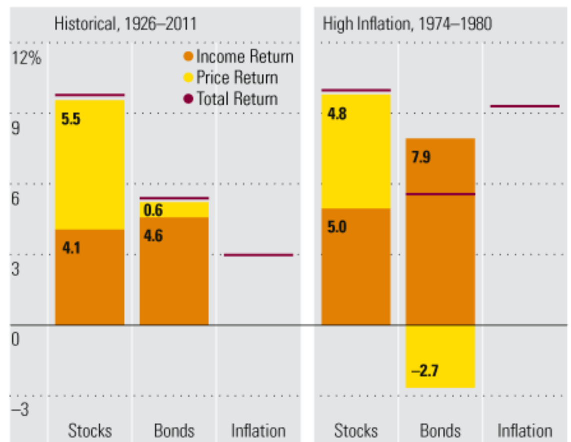
Dividends and Inflation

As an investor, you may ask if an allocation to dividend stocks in your retirement portfolio will help keep up with inflation. Examining stock returns during periods of high inflation may answer this question. Dividend-paying stocks may offer benefits such as stability through income return and inflation protection. While stock prices tend to be volatile, dividends may serve as a stable component of total return and may provide better inflation protection compared with bonds. Between 1974 and 1980 (high inflation period), the average rate of inflation was 9.3%, much higher than the historical rate of 3%. During this time, bonds yielded 7.9% from income, but prices declined by 2.7%, resulting in a total return of 5.6%—way short of inflation. On the contrary, stocks returned a total of 10%: 5.0% from dividend income and 4.8% from price return, outpacing inflation for this time period.

Performance of Stocks and Bonds Relative to Inflation



The 1974–1980 time period was chosen as representative of high inflation because it contains multiple consecutive years when inflation was 5% of higher (except 1976). The sum of the price return and income return may not equal the total return due to compounding. Past performance is no guarantee of future results. Dividends are not guaranteed. Diversification does not eliminate the risk of experiencing investment losses. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes. Stocks are represented by the Standard & Poor's 90 index from 1926 through February 1957 and the S&P 500® index thereafter, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Bonds are represented by the 5-year U.S. government bond and inflation by the Consumer Price Index.

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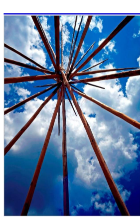

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How to Cope with Financial Anxiety

No one likes uncertainty. We want to maintain at least the illusion of control. But that's almost impossible to do today, given the volatility of the stock market and employers' belt-tightening. Even the steadiest hand is shaking just a little. It is imperative to avoid letting your emotions get in the way of making smart investment decisions. In times of doubt, it might be in your best interest to follow these steps for re-examining your current financial strategy.

Reassess Your Risk Tolerance: Today's investor is living those “hypothetical” questions that appear on risk-tolerance questionnaires. If you haven't checked your risk tolerance (the degree of uncertainty that you can handle in your investment portfolio) in more than a year, you're most likely due—especially if you're uncomfortable right now. Maybe you've taken on more risk than is prudent. If so, it might be in your best interest to change your asset mix. If you find that you're taking on the appropriate amount of risk for your goals, just sit tight.

If You Have to Do Something, Review Your Expenses: When dealing with uncertainty, some people feel compelled to act. Instead of trying to time the market (which even the professionals can't do with any consistency), focus on things you can control with certainty: expenses. Identify where you can tighten your belt. Try to identify unneeded or underused services. After such cuts, you’ll have some extra cash to invest each month. Expenses also matter in investment accounts. Do you know what you’re paying in expense ratios, 12b-1 fees, front- or back-end loads? Burn up some of your nervous energy by making sure those expenses aren’t eating up what little positive returns you might have.

Create a Shopping List of Investments: Research stocks or funds that would complement your portfolio, then see where they are currently trading. This could be a great opportunity to pick up some of your favorite picks at rock-bottom prices. However, make sure they are trading at historical lows because of investor overreaction and not because they are no longer financially sound.

Win the Psychological Battle: Don't let the financial media scare you into making poor investment decisions. Times of great uncertainty are usually bad times to be making major decisions. What is healthy is knowing how the human mind works and factoring that into your investment decision-making process. Researchers and academics in the field of behavioral finance attempt to better understand and explain how emotions and perceptions influence investors and their decisions. If you are interested in learning more, there are plenty of publications devoted to this relatively new field.

Consider all of the complex financial decisions faced by investors today. Without experience in different market environments or knowledge of market history, how might investors make such decisions? Potentially through their perceptions or based on their emotions. Thus, it is imperative that investors understand and combat the myriad of illusions to which they might be prone.

When the markets are doing well, people tend to think the trend will continue indefinitely. During the recent crisis when the market was struggling, we witnessed overreaction: Investors were running away from the stock market. However, if you think U.S. companies are still fundamentally strong and will profit in the next five to 10 years, then you should still have a stake in the stock market. Just make sure you set your asset allocation policy first, and then stay the course with an appropriate mix of stocks, bonds, and cash. Investing is a long-term proposition—don’t let your emotions overpower your sense of reason.

Stocks are not guaranteed and have been more volatile than bonds. Past performance is no guarantee of future results. Diversification does not eliminate the risk of experiencing investment losses.

Retirees: Non-Traditional Investment Risks

Volatile markets pose several challenges for retirees who rely on receiving a livable income stream from their investments. Interest rates are low and likely to stay low for the foreseeable future, making cash and high-quality bonds a safe parking place for now. Amid such a challenging environment, it's hard to blame retired investors for looking beyond traditional investments like stocks, bonds, and cash, or the mutual funds and exchange-traded funds that invest in these securities.

Many investors have flocked to gold and other precious metals, while others have gravitated toward investment types like life settlements, distressed real estate investments, and private mortgage investments. Such non-traditional investments might hold the promise of higher returns compared with traditional asset classes, but there is often a trade-off of higher risks and/or costs. Moreover, investors in non-traditional investments might not benefit from the same liquidity, transparency, and regulatory oversight that investors in traditional assets have. The following three asset types have picked up traction, but it is important to understand the risks before entrusting your hard-earned cash to them.

Life Settlements: A life settlement originates when a life insurance policyholder, often an elderly or terminally ill person, sells his or her interest in the policy to a third party, usually at a level that is well below the policy's stated death benefit. The third party then resells, often by issuing securities, that interest to investors who in turn must keep the policy in effect by paying its premiums. When the originally insured person dies, the owner of the security collects the death benefit. The rate of return on a life-settlement investment will hinge on when the originally insured person dies. If death occurs within his or her estimated life expectancy, the return will be relatively high. But if the original policy owner lives well beyond the expected time frame, a life settlement can be a poor investment. Not only will it take a while to pay off, but the investor will have to fork over premiums on a regular basis.

Distressed Real Estate: Distressed properties typically sell at prices lower than what the owners paid and may be under foreclosure; their prices may also be low in absolute terms. As with investing in any other security type, seeking low valuations is a key way to bring down your risk, but distressed real estate investing is far from a low-risk endeavor. Distressed properties may require substantial additional investment before they can be rented or resold, and there is no guarantee that a seemingly low-priced property won't fall further still. Finally, real estate can be illiquid, and for smaller investors can be cost-prohibitive to build a diversified portfolio of properties.

Private Mortgages: The troubled housing market has given rise to another real estate-related investment, the private mortgage. In contrast to a loan extended by a bank or financial institution, a private mortgage is funded by individuals, groups of individuals, or a corporation that specializes in making such loans. A private mortgage holder may be able to earn a substantially higher interest rate than he or she can earn on cash or high-quality bond investment. At the same time, the risks of a private mortgage loan are also a lot higher than cash or bonds, even though the loan is secured by the property. Individuals usually turn to the private mortgage market because they can't secure bank financing; thus, they might have poor credit or limited down payments. Those risks can be exacerbated because it can be difficult to diversify in the private mortgage market.

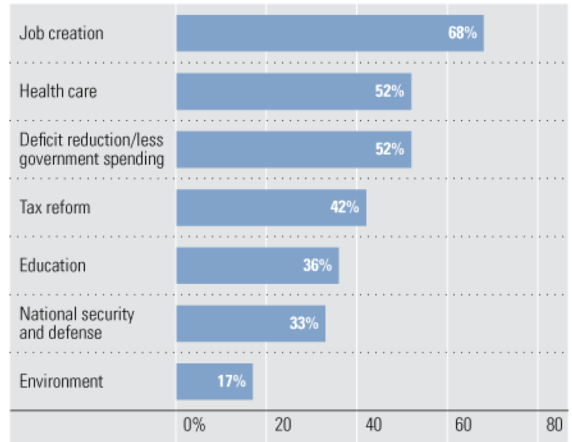
Retirees should exercise caution when investing in non-traditional assets. It is important to understand that investors in these non-traditional assets might have to give up transparency, liquidity, and regulatory oversight.

Health Care, a Central Election Issue in 2012

As soon as President Obama signed the Patient Protection and Affordable Care Act into law in 2010, critics and defenders of the legislation started a heated debate, which continues throughout the 2012 election season. Republicans like to point out the program's high cost and how it will likely increase the federal deficit; Democrats argue that short-term benefits of the law have already become apparent, and long-term benefits will include affordable health care to all Americans.

The image displays the percent of consumers who ranked each issue as first, second, or third most important factor in the 2012 presidential election. With the unemployment rate at 8.2% as of April 2012, it's no wonder voters are primarily concerned with job creation. Health care is the second most important factor on the list.

Percent of Consumers Who Ranked This as Most Important Factor



Source: "Top health industry issues of 2012: Connecting in uncertainty," PricewaterhouseCoopers Health Research Institute Report and Consumer Survey, November 2011. Unemployment rate from the Bureau of Labor Statistics.

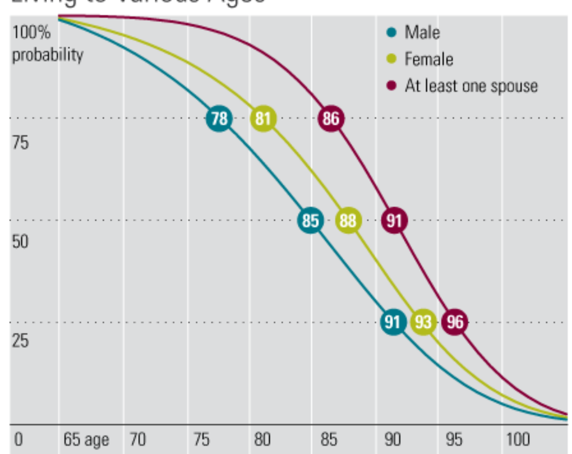
Bittersweet

The Merriam-Webster Dictionary defines bittersweet as something that is pleasant alloyed with pain. This could also be associated with retirement. The sweet part is that people are living longer thanks to innovations in healthcare. The bitter reality is that when people live longer they risk outliving their assets.

Longevity risk is the possibility of outliving one's retirement savings. While longevity is generally a good thing, the risks associated with it are becoming a major concern for individuals entering retirement.

Luckily, longevity risk can be managed through proper planning and products. To plan properly, consider when you would like to retire, the number of years you anticipate in retirement, and your desired income level.

Probability of a 65-Year-Old Living to Various Ages



Source: Annuity 2000 Mortality Tables—Transactions, Society of Actuaries, 1995–1996 Reports.

The Do-It-Yourself Health Savings Account

When deciding how much to set aside for an emergency fund, there is a growing category of expenses most people tend to overlook: potential out-of-pocket health-care costs. Even if you haven't opted for a high-deductible health-care plan, it's likely that your out-of-pocket health-care costs have jumped up substantially in recent years. Not only have health-care premiums increased dramatically, but so have the co-payments and deductibles associated with many health-care plans.

The magnitude of those numbers and the sobering statistics about the extent to which health-care costs can derail household finances suggest that households should make sure that their emergency funds include an allowance for health-care expenses that their plans don't cover.

This is the idea behind flexible-spending accounts, which enable you to set aside pre-tax dollars to pay for out-of-pocket costs not covered by your health-care plan. You can use an FSA to cover everything from co-payments to prescription expenses to health-care costs that your plan did not pick up. Yet FSAs have an important downside: If you don't use the assets you've put in them, the money doesn't roll over to the next year. Unless you're able to anticipate your out-of-pocket costs with some level of precision (for example, you expect to be on a certain drug or see a certain specialist for the foreseeable future), the use-it-or-lose-it risks of putting too much money into an FSA outweigh the benefits.

On the other hand, health-care savings accounts do allow you to roll over your money from year to year. However, they're only available to participants in high-deductible health-care plans, which have lower premiums and higher deductibles than traditional health plans.

Given these two types of accounts, a two-part health-savings program, consisting of FSA assets plus additional assets held outside the FSA, may be worth considering. Such a two-part plan would work as follows.

Part 1: Flexible Spending Account. Fund an FSA with an amount that you think, with some degree of certainty, you'll be able to use on health-care expenses in the year ahead.

Part 2: Supplemental Health-Care Account. Create a separate pool of liquid assets to cover any additional out-of-pocket costs that arise once you've exhausted your FSA funds. How large should the supplemental health-care account be? Your company's out-of-pocket maximum, less your FSA amount, may be a reasonable amount if you can swing it. Unlike FSAs and the health-savings accounts that can be used in conjunction with high-deductible health-care plans, you can't put pre-tax money into your supplemental health-care account. However, the money in your supplemental account won't have to be spent in a single year. If you spend only a fraction of your supplemental account in year 1, you'd just need to top it back up in year 2.

Those who aren't already funding Roth IRAs could experiment with holding their health-savings account within a Roth. The pluses: You can withdraw your Roth IRA contributions at any time and for any reason without triggering taxes or a penalty, and if you don't end up spending your contributions to cover health-care costs, you can withdraw the assets on a tax-free basis during retirement.

Finally, be sure to track your out-of-pocket expenses for health care. If these costs exceed 7.5% of your adjusted gross income, you can deduct the amount over 7.5%.

Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Please consult with a financial or tax professional for advice specific to your situation.

Annuities: Beware of Excess Withdrawals

It's extremely important to understand the impact of withdrawals on a living benefit attached to an annuity contract. The most widely used living benefit today is the lifetime guaranteed minimum withdrawal benefit (Lifetime GMWB). These usually allow you to make withdrawals from your account up to an annual limit (usually 4–6% of your investment). If you withdraw more than that percentage, future payments may be reduced. Sometimes, an excess withdrawal triggers a reset of the base on which your guaranteed amount is calculated. These withdrawals can also negatively impact the account value and death benefit. Example: You purchase an annuity for $100,000 that allows you a guaranteed 5% annual withdrawal until you start receiving your monthly payments for life. You may withdraw $5,000 every year. If you take out more than $5,000, your annual guaranteed withdrawal amount may decrease, and you won't be able to take out as much the following year. An excess withdrawal of, say, $5,500 will trigger a reset of your benefit base to equal your current account value. If the current value of your investment sub-accounts is, say, $80,000, you now get 5% of $80,000: only $4,000. The examples presented herein are for informational purposes only. They are not representative of any specific annuity and do not constitute investment advice. Annuities are suitable for long-term investing, particularly retirement savings. 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 apply for living-benefit options. Investment restrictions may also apply for all living-benefit options. Violating the terms and conditions of the annuity contract may void guarantees. Read your prospectus carefully for all the fees and expenses that may apply to your variable annuity contract. It is also recommended that you consult with a financial advisor and tax advisor before purchasing an annuity.

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