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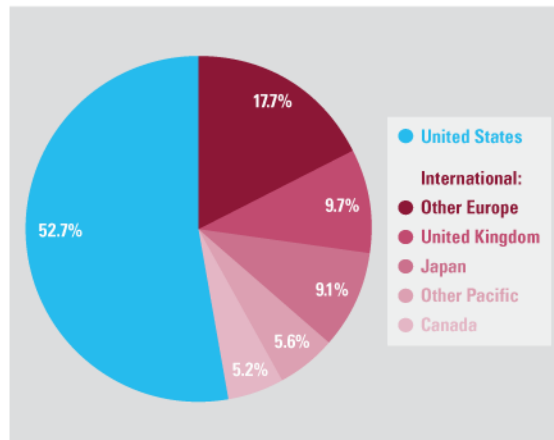
A World of Opportunity

As trade barriers continue to break down, the world economy has become a small neighborhood. Should investors seek to participate in this wave of globalization, or are they getting all they need here at home?

Historically, foreign investments have acted in a significantly different way from domestic investments. When the U.S. market slumped, various opportunities abroad have prospered. An American investor who put some money into foreign markets may have reduced risk while still attaining attractive returns. With the spread of globalization, this benefit decreases as companies across the globe are acting more like each other. However, as the image illustrates, an investor who doesn't take advantage of options outside of the United States is missing out on roughly half of the investable developed stock market opportunities in the world.

World Stock Market Capitalization
Year-End 2011



International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.

Source: World Market Capitalization by Country is from the Morgan Stanley Capital International Blue Book℠. The data is expressed in U.S. dollars.

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Dividends and Total Return

Income is important to consider when choosing an investment. Especially important for investors approaching retirement, income can add meaningfully to one's total return, which comprises income and price return (capital appreciation). Investors can pursue income returns in many ways including bonds, real estate investment trusts, and stocks.

Stock income is typically paid in the form of a monthly, quarterly, annual, or special cash dividend, which can be used to finance current consumption or to reinvest. Dividends are typically expressed in terms of yield. Like an interest rate, yield is represented as a percentage rate and is calculated by taking the annual cash dividend divided by a stock's current price. For example, a stock trading at $20 with a future annual cash dividend of $1 would have a dividend yield of 5%.

Keep in mind, though, that there is no guarantee a dividend will be paid, even if a certain company has a consistent dividend-paying track record. A company can increase, decrease, and even eliminate dividends altogether, depending on its financial situation. Furthermore, if a dividend is declared, the company has to pay dividends for preferred shares first, before any common share dividends can be paid.

Although stocks can be a source of income return, not all stocks are created equal in this regard. Some companies distribute significantly more of their profits in the form of dividends than others, and some don't distribute dividends at all. The following image demonstrates this point. Historically, dividend-earning stocks—represented by Morningstar's Dividend Composite Index—have had compound annual returns of 6.6%, while large stocks have had compound annual returns of 4.3%. Additionally, higher-yielding companies—represented by Morningstar's Dividend Leaders Index—have outperformed large stocks: Dividend Leaders Index components had a compound annual return of 9.0% compared with 4.3% for large stocks during the period studied. For investors looking both for income and total returns, dividend-paying stocks can be a reasonable place to invest.

Although higher-yielding stocks have demonstrated an ability to outperform large stocks, all that glitters is not gold. Dividends are paid at a company's discretion, and exceptionally high yields can indicate a potential dividend cut. For example, had investors been lured to many high-yielding bank stocks in late 2008, they would have been sorely disappointed when many banks subsequently cut their dividends as profitability declined during the credit crisis. When looking at dividend-paying stocks, investors should focus on reasonable dividend yields with companies that have the earnings power to increase their dividend distributions over time. Many large companies with recognizable brand names have demonstrated an ability to offer this slow and steady income distribution to shareholders.

Dividend-Paying Stocks May Provide Better Returns

This is for illustrative purposes only and not indicative of any investment. Assumes reinvestment of all income and no transaction costs or taxes. 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. Dividends are not guaranteed and are paid solely at a company's discretion.

Source: Large Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general; Dividend-Paying Stocks—Morningstar Dividend Composite Index; High-Yield Dividend-Paying Stocks—Morningstar Dividend Leaders Index. Stocks in both indexes have a consistent record of dividend payment, have the ability to sustain their dividend payments and are weighted in proportion to the total pool of dividends available to investors. The Morningstar Dividend Composite Index captures the performance of all stocks in the U.S. Market Index. The Morningstar Dividend Leaders Index captures the performance of the 100 highest-yielding stocks.

Three-Step Checklist for Turbulent Markets

When the stock market experiences extreme volatility, an investor's best bet is to focus his/her energy on factors that can be controlled. Unfortunately, many investors panic-sell and lose their money. When the market rebounds, many investors are left wondering if it's the right time to get back in.

Your best bet during turbulent markets is an investment of time. You want to invest in time to see where you stand now, and, if you determine changes are in order, thoroughly research your options. Here is a three-step checklist to manage your investments during turbulent markets.

Step 1: Check adequacy of cash reserves.

The best way to manage your portfolio during volatile markets is to make sure you have adequate cash on hand to cover your near-term needs. This way, your long-term stock investments can ride out the market ups and downs, but you can take comfort in knowing that they won't affect your ability to fund short-term cash needs.

Step 2: Check your long-term positioning.

Once you've done the liquidity check, the next step is to check the asset allocation of your long-term assets. Market sell-offs can be alarming for retirees and people getting close to retirement simply because they typically have more money invested, compared with their younger counterparts. Checking your long-term positioning helps you put things into perspective so that you can make sound investment decisions for your future.

Step 3: Initiate defensive hedges with care.

During turbulent markets, investors may initiate defensive strategies like selling out of stocks and buying into the so-called "safe" investments like gold. Gold and treasuries can serve as a legitimate defensive role in a portfolio; however, these investments may have already enjoyed a sizable run-up. If you're moving into either, do so with caution, and only after you've checked your existing exposure to those asset classes.

Treasuries are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. Debt securities are subject to credit/default risk and interest-rate risk (they have varying levels of sensitivity to changes in interest rates). In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest rate changes.

Gold/commodity investments will be subject to the risks of investing in physical commodities, including regulatory, economic and political developments, weather events, natural disasters, and market disruptions. Exposure to the commodities markets may subject the investment to greater volatility than investments in more traditional securities, such as stocks and bonds.

Reducing the IRS' Bite with Tax-Efficient Funds

Handing over a portion of your investment earnings to the IRS is never pleasant. Fortunately, a specific category of mutual funds, called tax-efficient funds, might help you keep the amount you send to Uncle Sam to a minimum. Here's how tax-efficient funds work. Mutual funds must pay you almost all of the money they make from interest, dividends, or capital gains (money made from selling stock) in a year. That's called a taxable distribution (since you must pay taxes on that money). Tax-efficient funds keep their taxable distributions as small as possible, thus lowering the amount you have to pay in taxes. Tax-efficient funds can use several strategies to keep distributions low. They avoid stocks that pay dividends. They don't sell their stocks very often. When they do sell stocks, they might also try to sell some that have lost money to offset those that have made money. They could also hold stocks for more than one year before selling, since the profits are taxed at a lower long-term capital gains rate than short-term transactions. These methods, as well as some others, keep your tax bill lower.

While tax-efficient funds seem extremely attractive, there are a few drawbacks to note. First, there are only a handful of these funds available from which to choose (relative to other categories). Second, of the funds that do exist, few have long-term investment records that you can analyze. Finally, most tax-efficient funds stick mainly with large-company stocks and tax-free (municipal) bonds. That means you might have to look at non-tax-efficient funds to get exposure to other types of investments in an effort to build a diversified portfolio.

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results.

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